TAX TREATMENT OF FINNISH PRIVATE EQUITY FUNDS AND THEIR FOREIGN INVESTORS IN FINLAND

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Author: Isabella Kartila
Supervisor: Marjaana Helminen
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Tiivistelmä – Referat – Abstract

Private equity plays an important role in driving economic growth in Finland by creating jobs, generating returns for investors, and developing businesses of Finnish companies. In 2018, Finnish start-ups and growth companies received investments amounting to 479 million euro of which 101 million euro were invested by Finnish private equity funds and 103 million euro by foreign private equity funds. Hence, approximately 43% of the investments in the start-ups and growth companies were made by private equity funds. Although private equity investments have a significant role in Finland, the amount of foreign capital in Finnish private equity funds has been more limited in comparison with their foreign peers. In 2017, only 30% of investments in Finnish private equity funds were made by foreign investors, whereas the corresponding figure in Europe was on average 50% and in Sweden even 80%.

The main purpose of this thesis is to examine the tax treatment of income derived by foreign investors through Finnish private equity funds. Since taxation is one of the decisive factors affecting the attractiveness of Finnish private equity funds from the perspective of foreign investors, the topic of the research is of major importance for the private equity industry. Moreover, the research is highly topical as the Finnish tax laws governing the tax treatment of foreign investors in Finnish private equity funds were only recently amended. Despite the importance of the topic, specific legal research on it is very limited.

Prior to the tax year 2019, foreign investors were not able to invest in Finnish private equity funds through funds of funds without a risk of double taxation. A similar problem occurred in the early 2000s when Finland was deemed to have an unfavourable tax environment in terms of fund structures as foreign investors were not able to make tax efficient investments in Finnish private equity funds. The inefficiency resulted from legal praxis and Finnish tax laws under which foreign investors in Finnish private equity funds were liable to tax in Finland on all income received through the funds. Whereas in case of direct investments in portfolio companies or investments made through foreign private equity funds, only part of the income would have been subject to tax in Finland.

For the purposes of neutralising taxation and improving competitiveness of the Finnish private equity industry, Section 9(5) of the Income Tax Act (30.12.1992/1535) was enacted in 2006. The thesis shows that when the special tax regime is applied, tax consequences are the same as they would be if foreign investors received the income directly from portfolio companies. Hence, the special provision enables foreign investors to make tax efficient direct investments in Finnish private equity funds. In 2019, the special tax regime enabling a flow-through tax treatment of income received by foreign investors in case of direct investments in Finnish private equity funds was extended to also cover foreign investors investing through funds of funds.

The thesis discovers that as of the beginning of the tax year 2019, foreign investors have been able to invest both directly and indirectly in Finnish private equity funds without a risk of double taxation. This study provides the first comprehensive analysis of the conditions imposed on Finnish private equity funds, foreign investors, and funds of funds by the special tax regime. In the course of the research, some challenges related to the application of the special tax regime surface. The extensive analysis reveals that the requirement of Finnish private equity funds to be alternative investment funds excludes some actors from the scope of application of the special tax regime. Moreover, the condition demanding foreign investors to reside in a state that has a tax treaty with Finland entails challenges related to their tax assessment in Finland.

Despite the challenges discovered in the analysis, the thesis concludes that the recent legislative amendment extending the scope of application of the special tax regime to foreign investors investing through funds of funds has made Finnish private equity funds more attractive target funds for foreign investors. In the light of the findings of the thesis, the difference in the percentage of foreign investments in Finnish and Swedish private equity funds should decrease at least to the extent that the gap resulted from tax reasons.

Avainsanat – Nyckelord – Keywords
Finnish Private Equity Funds, Foreign Investors, Funds of Funds, Private Equity Activities, Limited Tax Liability, Withholding Taxation, Pääomasijoitusrahastot, Rajoitetusti verovelvolliset sijoittajat, Rahastojen rahastot, Pääomasijoitustoiminta

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Marjaana Helminen, Professor of International and Comparative Tax Law at the University of Helsinki

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Hallituksen esitys eduskunnalle laeiksi tuloverolain 9 §:n ja rajoitetusti verovelvollisen tulon ja varallisuuden verottamisesta annetun lain muuttamisesta (Government Proposal 64/2005 vp)

Hallituksen esitys eduskunnalle laiksi avoimesta yhtiöstä ja kommandiittiyhtiöstä annetun lain muuttamisesta (Government Proposal 17/2015 vp)

Hallituksen esitys eduskunnalle laeiksi elinkeinotulon verottamisesta annetun lain, tuloverolain ja eräiden muiden lakien muuttamisesta (Government Proposal 257/2018 vp)

Hallituksen esitys eduskunnalle laeiksi tuloverolain ja elinkeinotulon verottamisesta annetun lain 6 §:n muuttamisesta (Government Proposal 256/1994 vp)

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Hallituksen esitys eduskunnalle laiksi tuloverolain 9 §:n muuttamisesta (Government Proposal 306/2018 vp)

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Interview with Jaana Mikkola, Ministerial Adviser at the Tax Department of the Finnish Ministry of Finance. Interviewed by Isabella Kartila in a face-to-face meeting in Helsinki on 29 May 2019. (Interview with Mikkola 2019)

Interview with Pia Santavirta, the Managing Director of the Finnish Venture Capital Association. Interviewed by Isabella Kartila over telephone on 14 June 2019. (Interview with Santavirta 2019)

Interview with Harri Vehviläinen, Counsel at Hannes Snellman Attorneys Ltd. Interviewed by Isabella Kartila in a face-to-face meeting in Helsinki on 19 June 2019. (Interview with Vehviläinen 2019)

Figures

LIST OF ABBREVIATIONS

Act on Taxation of Non-residents	Act on the Taxation of Income of a Person Subject to Limited Tax Liability (11.08.1978/627, as amended)
Administrative Cooperation Directive	Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC [2018] OJ L 64/1
AIFM Act	Act on Alternative Investment Fund Managers (7.3.2014/162, as amended)
AIFM Directive	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2019] OJ L 174/1
Anti-Tax-Avoidance Directive	Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L 193/1
BITA	Business Income Tax Act (24.6.1968/360, as amended)
EBITD	Earnings before interest, tax, and depreciation
ECJ	European Court of Justice
EEA	European Economic Area
EU	European Union
EU Member States	Member states of the European Union
EuSEF	European Social Entrepreneurship Fund
EuVECA	European Venture Capital Fund
EVCA	European Private Equity and Venture Capital Association
FITA	Act on the Taxation of Farm Income (15.12.1967/543, as amended)
FTA	Finnish Tax Administration
FVCA	Finnish Venture Capital Association
Ibid	ibidem (at the same place, in a publication quoted before)

Interest-Royalties Directive	Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States [2013] OJ L 157/49
IPO	Initial public offering
ITA	Income Tax Act (30.12.1992/1535, as amended)
KVL	Central Tax Board of Finland (*Keskusverolautakunta* in Finnish)
Merger Directive	Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States [2013] OJ L 310/34
Nordic Tax Treaty	Agreement to avoid double taxation with respect to taxes on income and on capital concluded between Denmark, the Faroe Islands, Finland, Iceland, Norway, and Sweden (SK 412/1997, SopS 26, as amended)
OECD	Organization for Economic Co-operation and Development
OECD Model	Model Tax Convention on Income and Capital of the Organization for Economic Co-operation and Development
Parent-Subsidiary Directive	Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2015] OJ L 345/8
Partnership Act	Act on General Partnerships and Limited Partnerships (29.4.1988/389, as amended)

Recovery Directive	Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance [2019] OJ L 173/190
SAC	Supreme Administrative Court of Finland (*Korkein hallinto-oikeus* in Finnish)
TEU	Consolidated version of the Treaty on the European Union [2012] OJ C 326/13
TFEU	Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ C 326/47
UCITS Directive	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [2019] OJ L 302/32
US	United States
VAT	Value added tax
VCLT	Vienna Convention on the Law of Treaties (United Nations) 1155 UNTS 331

1 INTRODUCTION

1.1 Background

‘In venture capital, size matters! With VentureEU[1], Europe's many innovative entrepreneurs will soon get the investment they need to innovate and grow into global success stories. This means more jobs and growth in Europe.’[2] The statement by *Jyrki Katainen*, the Vice-President of the European Commission from 2014 to 2019, highlights the significance of private equity and venture capital (hereinafter jointly private equity[3]) in the modern financial markets. Traditionally, the Finnish financial markets have been bank-centred and debt-dominated as banks have been the main providers of external funding[4]. In line with the global trend, private equity has, however, become one of the most important financial market players in driving economic growth in Finland[5].

Finnish private equity investors invest approximately an aggregate of half a billion euro in over 200 Finnish companies on an annual basis[6]. Between 2014 and 2018, Finnish private equity funds received approximately 2.9 billion euro for the purpose of investing in start-ups and growth companies[7]. In 2018, these companies received investments up to 479 million euro of which 101 million euro were invested by Finnish private equity funds and 103

[1] VentureEU is a Pan-European Venture Capital Funds of Funds programme launched by the European Commission and the European Investment Fund on 10 April 2018. The programme aims to boost investments in innovative start-up and scale-up companies across Europe by supporting six funds in their mission to invest in the European venture capital market. These funds are aiming to raise up to 2.1 billion euro, which is expected to trigger an estimated 6.5 billion euro of new investments in innovative start-up and scale-up companies, doubling the amount of venture capital currently available in Europe. See more in Press release of the European Commission, 2018.
[2] *Jyrki Katainen* stated this in connection with the launch of the VentureEU on 10 April 2018.
[3] Private equity activities may be divided, e.g., into venture capital and buyout activities. Venture capital activities refer to the financing of start-ups and growth companies, whereas buyout activities refer to the financing of, for example, different kinds of acquisitions, expansion projects, and corporate turnarounds. See more in Government Proposal 306/2018 vp, 3; and Industry study by the FVCA and KPMG 2019. In this thesis, the term ‘*private equity activities*’ is used as an overall term for all venture capital and buyout activities.
[4] The traditional set-up underwent a remarkable reform over the time period from 1980 to 2000 as a result of the liberalisation of the financial markets in 1980s, the financial crisis in the early 1990s as well as the growth of stock market and number of foreign investors in the late 1990s. These circumstances enabled the introduction of new financing options, such as private equity funding, to the financial markets. See Vapaavuori 1991, pp. 19–25; Ali-Yrkkö – Hyytinen – Liukkonen 2001, pp. 8–9; Hyytinen – Pajarinen 2001, pp. 4–10; and Lauriala 2004, p. 14.
[5] Private equity activities started in the end of 1980s in the US from where they slowly expanded to the European markets. The first Finnish private equity funds were established in the early 1990s. See Lauriala 2004, pp. 13–14; and Passinen 2007, p. 38. For more on the significant role of private equity funding in the global financial markets, see, e.g, Talmor – Vasvari 2011, p. 21; Demaria 2013, p. 6; and Lee *et al*. 2014, pp. 12–13.
[6] The Bank of Finland collects data on private equity funds registered in Finland, and the figure presented herein is from Statistics of Bank of Finland 2018.
[7] See Annual review of the FVCA 2018.

million euro by foreign private equity funds. This means that approximately 43% of the investments in Finnish start-ups and growth companies came from private equity funds.[8]

The figures at hand illustrate that private equity is not only a significant asset class for investors but also an extremely important source of funding for growing companies. The remarkable role of private equity in the financing and development of portfolio companies is broadly acknowledged. The FVCA[9] and KPMG Finland recently published an industry study on private equity investors' impact on portfolio companies over the time period from 2010 to 2017[10]. The study shows that private equity backed companies are among the fastest growing companies in Finland as their turnover has grown on average six times faster than in their peer companies. Moreover, the study reveals that the number of personnel in such companies has increased on average 15 times faster compared to peers.[11]

In the light of the foregoing considerations, promoting the growth and competitiveness of the Finnish private equity industry is likely to have a positive effect on economic growth in Finland. In 2017, the proportion of investments made by foreign investors[12] in Finnish private equity funds was 30%[13], whereas the corresponding figure in Europe was on average 50%[14]. In Sweden, 80% of all investments made in Swedish private equity funds were made by foreign investors in 2017[15]. Accordingly, foreign investors represent one of the largest growth potentials to Finnish private equity funds. Considering the above, the Finnish legislation should not deter foreign investors from investing in Finnish private equity funds. However, until this year Finnish tax rules did indirectly restrain foreign investors from investing in Finnish private equity funds through funds of funds[16].

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[8] Press release of the FVCA 2019b.
[9] The FVCA is the industry body and public policy advocate for the venture capital and private equity investors in Finland.
[10] The industry study was published on 24 January 2019. The study was based on the financial figures of 489 Finnish companies owned by private equity investors. See Industry study by the FVCA and KPMG 2019.
[11] See more in Industry study by the FVCA and KPMG 2019.
[12] In this thesis, the term '*foreign investors*' refers to investors who are subject to limited tax liability in Finland. To be precise, the correct term would be '*non-resident investors who are subject to limited tax liability in Finland*', because foreign investors might be understood too narrowly to only refer to investors not possessing Finnish nationality. Accordingly, and also for presentational purposes, foreign investors refer to non-resident investors who are subject to limited tax liability in Finland, regardless of their nationality.
[13] Government Proposal 306/2018 vp, p. 20.
[14] See Comments of the FVCA 2018.
[15] *Ibid*.
[16] In this thesis, the term '*fund of funds*' implies to private equity funds investing in other private equity funds. One of the main objectives of funds of funds is to achieve a broader diversification of investments and minimise risks by investing in a variety of private equity funds. See more about the systematics of funds of funds in, e.g., Hidén – Tähtinen 2005, pp. 22–24; Talmor – Vasvari 2011, pp. 152–168; and Demaria 2013, pp. 77–81.

1.2 Specific Purpose and Scope of the Study

The purpose of this thesis is to examine the tax treatment of income derived by foreign investors through Finnish private equity funds. In the early 2000s, Finland was deemed to have an exceptionally unfavourable tax environment in terms of fund structures as foreign investors were not able to make tax efficient investments in Finnish private equity funds [17]. The inefficiency resulted from the Finnish tax laws under which foreign investors investing through Finnish private equity funds were liable to tax on all income received through the funds. Whereas in case of direct investments or investments made through foreign private equity funds, only part of the income would have been subject to tax in Finland.[18]

The Finnish tax laws governing the tax treatment of foreign investors were amended, first, in 2005, and subsequently in 2019[19]. One of the main objectives of the legislative amendments was to neutralise the tax treatment of direct and indirect investments in Finnish companies[20]. After all, the starting point of a good tax system is that the tax treatment of portfolio investments made through investment funds[21] is as neutral as the tax treatment of direct investments[22]. As a result of the amendments, foreign investors have been able, under certain circumstances, to invest both directly and indirectly in Finnish private equity funds in a tax efficient manner[23].

Before addressing the Finnish tax laws governing the tax treatment of foreign investors in Finnish private equity funds, a solid framework has to be established for the study. At first, a typical legal structure and certain special characteristics of Finnish private equity funds are introduced. Since foreign investors investing in Finnish private equity funds derive income through the funds, it is essential to determine the tax treatment of Finnish private equity funds as well for the purposes of in-depth understanding of the taxation of foreign investors

[17] See EVCA 2003, pp. 7, 12.
[18] See, e.g., Government Proposal 64/2005 vp, pp. 2–3.
[19] Government Proposal 64/2005 vp; and Government Proposal 306/2018 vp.
[20] Government Proposal 64/2005 vp, p. 3; and Government Proposal 306/2018 vp, p. 12.
[21] In Finnish, the term '*investment fund*' refers to a certain legal form of funds that are established for the purposes of collective investments. However, in this thesis the term '*investment funds*' means funds in any legal form established for the purposes of collective investments, unless otherwise specified.
[22] See, e.g., Tikka 1990, pp. 47–62. See also Viitala 2018, p. 529.
[23] In this context, one should note that foreign investors were not fully restricted from using funds of funds in their private equity activities. However, tax efficiency of these investments required at least one corporate entity to be in between the funds of funds and Finnish private equity funds. In other words, funds of funds were only restrained from being direct partners in Finnish private equity funds. According to *Santavirta*, the use of funds of funds was, however, only possible to investors who had enough resources in terms of money and time and a very significant interest in investing in Finland. Moreover, such investors had to be ready to make their legal structures more complex for the sake of the investments. Interview with Santavirta 2019.

in Finnish private equity funds. Hence, a brief overview is provided of both private law and tax law aspects on Finnish private equity funds.

Nevertheless, the main focus of the thesis lies in the tax treatment of foreign investors in Finnish private equity funds. A study analysing the taxation of foreign investors in Finnish private equity funds is a highly topical issue of major importance for the private equity industry. This is due to the fact that taxation is one of the decisive factors affecting the attractiveness of Finnish private equity funds from the perspective of potential foreign investors[24]. Moreover, since the tax regime governing the tax treatment of foreign investors in Finnish private equity funds has only recently been amended, a thorough examination of the new rules is definitely called.

The overall objective of this thesis is to provide answers to the following research questions:

1) What is the tax treatment of Finnish private equity funds and their foreign investors under Finnish tax laws?
2) What are the effects of tax treaties and EU law to the tax treatment of foreign investors in Finnish private equity funds?
3) Have the legislative changes managed to improve the competitiveness of and attract foreign capital into Finnish private equity funds?
4) What kinds of further amendments should be taken into consideration *de lege ferenda* for the purpose of improving the global market positioning of Finnish private equity funds?

With regard to the scope of the research, this thesis focuses merely on tax issues related to foreign investors in Finnish private equity funds. Hence, tax aspects regarding other forms of investment funds than private equity funds are omitted in this study. Another major limitation concerns the taxation of other partners than foreign investors in Finnish private equity funds. Despite the international nature of the study, the study addresses merely tax consequences in Finland, leaving the tax treatment of foreign investors in their state of residence for future studies. Furthermore, the scope of this thesis is narrowed to income taxation. Hence, all other types of direct taxes as well as all indirect taxes are left out of the scope of this study.

[24] See Hidén – Tähtinen 2005, p. 46; and Järvenoja 2013, p. 326.

1.3 Approach and Research Methods

There are numerous research methods in legal writing. Every author has to find the most suitable research method on the basis of the topic and type of questions of their research[25]. The method should be determined by the topic and questions due to the fact that the method together with the approach on research questions determine the perspective of the study[26]. The most common method in legal writing is a legal dogmatic method. The aim of the legal dogmatic method is to study existing legal norms and discover their content by interpreting and systematising them[27]. Since this thesis examines the tax treatment of foreign investors in Finnish private equity funds by analysing existing Finnish international tax law provisions (*de lege lata*), the most suitable method for this research is the legal dogmatic method.

In addition to the legal dogmatic method, a qualitative research method is employed in this thesis for *de lege ferenda* purposes. The qualitative part of the study comprises four interviews. Firstly, *Nikke Jokitie*, a representative of the FTA, was interviewed so that a better understanding of problems related to the tax assessment of foreign investors in Finnish private equity funds was reached. The interview also offered a unique opportunity to discuss the FTA's views on the Finnish tax laws governing the tax treatment of foreign investors in Finnish private equity funds as *Jokitie* participated in commenting the draft version of the law amending the tax treatment of the foreign investors in 2019.

Secondly, the author interviewed *Jaana Mikkola*, a representative of the Finnish Ministry of Finance. *Mikkola* is an expert in the special tax regime governing the tax treatment of foreign investors in Finnish private equity funds as she worked as the rapporteur of the legislative amendment in 2019. Moreover, she acted as the secretary of the working group of the Finnish Ministry of Finance analysing the tax treatment of different forms of investment, including Finnish private equity funds, in terms of their functioning and neutrality during the period from 2017 to 2018. The interview provided the author with invaluable information regarding the process of the recent amendment.

Thirdly, the author interviewed *Pia Santavirta*, the CEO of the FVCA, for the purpose of understanding the private equity market actors' perspective on the Finnish regulative environment and challenges faced by them. Last but not least, *Harri Vehviläinen,* an

[25] Kolehmainen 2016, pp. 111–112.
[26] Husa – Mutanen – Pohjolainen 2008, p. 27.
[27] Aarnio 1978, p. 52; Timonen 1998, p. 12; and Hirvonen 2011, p. 22.

attorney-at-law at Hannes Snellman Attorneys Ltd, was interviewed for the thesis. The interview offered a great insight into the viewpoint of a legal adviser interpreting the rules governing the tax treatment of Finnish private equity funds and their partners.

1.4 Sources of Law

1.4.1 Domestic Doctrine

The extensive use of source material is essential in order to provide thorough answers to the research questions at hand. This Subchapter 1.4 determines which sources of law may be utilised in a legal dogmatic research and how they should be interpreted. Since legal dogmatism is based on hermeneutics, it is bound by language and the understanding of language. If a clause is considered to be semantically weak, other sources of law than merely statutes must be used for the purposes of drawing conclusions and providing for a stronger argumentation.[28] In judicial literature, *Aarnio* and *Peczenik* have developed a Nordic doctrine on the sources of law, which is well-established in the Finnish legal tradition. The doctrine divides all sources of law into three categories according to their legal bindingness. These categories are strongly binding sources of law, weakly binding sources of law, and permitted sources of law.[29]

The Finnish tax system is characterised by the principle of legality, laid down in Section 81 of the Finnish Constitution. The provision stipulates that state tax is governed by an act, wherein provisions on the grounds for tax liability, the amount of tax and provisions on the legal protection of the taxpayer are included. The provisions are designed to be accurate and precise leaving the tax authorities with only a limited margin of discretion[30]. Due to the principle of legality, the wording of the provision is given priority. However, the wording of the provision is never exhaustive, and thus other sources of law are required in order to solve interpretation problems.[31]

The Finnish Constitution, including the principle of legality, is a strongly binding source of law together with other Finnish acts[32]. Weakly binding sources of law, in turn, include

[28] Aarnio 1997, pp. 52–59.
[29] See more about the Nordic doctrine on the sources of law in Aarnio 1989, pp. 220–221; and Peczenik 1995, pp. 35–36. See more about the Nordic doctrine in the context of Finnish tax law in Määttä 2014, pp. 8–22.
[30] Government Proposal 1/1998 vp, p. 134.
[31] Myrsky 2004, pp. 44–46; Wikström 2008, pp. 23–29; and Määttä 2014, p. 14.
[32] In addition to the norms of statutory law, established custom is traditionally regarded to be a strongly binding source of law. However, established custom lack practical relevance in the field of taxation due to the principle of legality, expressed in Section 81 of the Finnish Constitution. See Myrsky 2004, pp. 46–48; and Määttä 2014, p. 319.

preparatory works[33] and court decisions. In the context of Finnish tax law, the most relevant court decisions are the published rulings of the SAC.[34] Judicial literature, general legal principles, comparative law[35], and real arguments are considered as permitted sources of law[36]. In addition, guidance issued by the FTA is a permitted source of law[37]. The Nordic doctrine on the sources of law has been criticised for not reflecting the binding effect of all sources of law as EU law and tax treaty law provisions are not traditionally placed in the hierarchy[38]. The position of these provisions is addressed in the following sections.

1.4.2 International Context

When investors inject capital into foreign companies, they step into the area of international tax law. International tax law is a segment of tax law comprising all tax law rules regarding cross-border economic relations. International tax law rules govern cross-border situations where persons, income, and capital are simultaneously linked to several states. Many international tax law rules relate to the extent of taxing powers of different states in cross-border situations.[39] Each state determines the territorial extent of its own taxing powers by specifying when a connection between the state and a tax subject or tax object triggers taxation in that state[40]. Accordingly, Finland determines *per se* when a tax subject or tax object is connected to it in a way that triggers taxation in Finland.

International tax law of Finland consists of domestic international tax law, tax treaty law, and EU law[41]. Each of these legal systems of Finnish international tax law has its own rules, language, and concepts. These differences may create conflicts that must be solved before

[33] One should note that different committee reports are seldom utilised as sources of law when interpreting Finnish tax law provisions. See Määttä 2014, p. 15.
[34] Published court decisions of the SAC are considered primary to its unpublished court decisions, published court decisions of Finnish Administrative Courts and advance rulings of the KVL. See more in Myrsky 2004, pp. 48–50; and Määttä 2014, pp. 15, 320. See more about the role of advance rulings in the systematics of tax law in Myrsky 2011.
[35] It should be noted that foreign court decisions may be accepted as a permitted source of law, especially in situations where the domestic provisions interpreted are similar to the provisions interpreted in a foreign case concerned. See Määttä 2014, p. 271.
[36] Määttä 2014, pp. 14–16. For information on the use of judicial literature as a source of law, see Myrsky 2004, pp. 50–51.
[37] See more in Määttä 2014, pp. 256–259. For the avoidance of doubt, guidance of the FTA is not legally binding towards the courts and taxpayers. See Wikström 2008, p. 25; and Määttä 2014, p. 262.
[38] Määttä 2014, p. 318.
[39] See Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Concept of International Tax Law, Rules on Cross-border Relations.
[40] Helminen 2019, Chapter 4, International Double Taxation and Double Non-Taxation, Territorial Extent of Taxing Powers.
[41] Helminen 2018, p. 26; and Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Concept of International Tax Law, Rules on Cross-border Relations.

determining the tax consequences in cross-border situations. Apart from EU law rules that are applicable in all EU Member States[42], international tax law is not of supranational nature. Consequently, international tax law rules may greatly differ from one state to another. All EU Member States have their own national tax system comprising separate legal systems that are in constant interaction with each other.[43]

The Finnish tax treaty law consists of bilateral and multilateral tax treaties[44] that Finland has concluded with other states[45]. It is essential to note that tax treaties may only limit or modify, but not extend the application of domestic tax law provisions[46]. In Finland, tax treaties have to be implemented in the national legislation. Consequently, tax treaties have a dualistic status as they are both international agreements and part of the national legislation.[47] This places them in the same hierarchical position with Finnish domestic tax laws. Despite the same hierarchical position, domestic tax law provisions are not allowed to override tax treaty provisions in cross-border conflict situations. Subsequently, tax treaty provisions take precedence in such conflict situations where they provide taxpayers with a more lenient tax treatment than domestic tax law provisions.[48]

With regard to EU law, one should note that the EU has only the competences conferred on it by the EU Member States in the TEU and the TFEU (also referred to as *the founding treaties*)[49]. All regulations, directives, decisions, recommendations, and opinions adopted by the EU institutions[50] are derived from and based on the founding treaties[51]. Although taxation is not explicitly expressed amongst the competences conferred on the EU, it is included in

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[42] Due to Finland's membership in the EU, the Finnish tax system is required to take into account EU law provisions as they are considered to be strongly binding sources of law together with the Finnish national legislation.

[43] See, e.g., Nykänen 2015, pp. 12–13; Helminen 2018, p. 27; and Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Relationship among the Legal Systems of International Tax Law.

[44] Tax treaties are international agreements between two or more sovereign states and in order to give effect to them, they have to be ratified by each contracting state. See more in Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Concept of International Tax Law, Treaty Process and Force of Tax Treaties.

[45] Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Concept of International Tax Law, Tax Treaty Law, Legal Framework and Purpose of Tax Treaties.

[46] Malmgrén – Myrsky 2017, p. 86; and Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Concept of International Tax Law, Relationship among the Legal Systems of International Tax Law, Tax Treaties and Domestic Tax Law.

[47] Malmgrén – Myrsky 2017, pp. 84–86; and Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Concept of International Tax Law, Treaty Process and Force of Tax Treaties.

[48] Nykänen 2015, pp. 37–39; Malmgrén – Myrsky 2017, pp. 86–88; and Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Concept of International Tax Law, Relationship among the Legal Systems of International Tax Law, Tax Treaties and Domestic Tax Law.

[49] Article 5 of the TEU. One should note that competences not conferred upon the Union in the Treaties remain with the Member states.' See more in Terra – Wattel 2019, p. 11.

[50] Article 288 of the TFEU.

[51] See Terra – Wattel 2019, p. 15.

the shared competence regarding the internal market[52]. The internal market is defined as an area without internal frontiers where goods, persons, services, and capital may move freely[53]. Hence, the legal basis for the free movement of goods, persons, services, and capital (also referred to as *the basic freedoms*) ensuring the proper functioning of the internal market exists under the TFEU[54].

Harmonisation of taxes has been a sensitive area of political discussion in the EU because the EU Member States consider their tax sovereignty as a fundamental part of their national sovereignty[55]. Indirect taxes have been regarded to be direct tax obstacles to the free trade of goods and services within the internal market due to fact that such taxes are imposed on transactions[56]. Consequently, the EU has harmonised indirect taxes in an extensive manner. For instance, internal customs duties have been replaced by outside border customs duties and national turnover tax bases have been harmonised. Furthermore, a common VAT system has been introduced in the EU.[57] Direct taxes, in turn, have a less direct effect on the functioning of the internal market as they are imposed on income and wealth[58]. Thus, the EU Member States have retained a broad sovereignty in the area of direct taxation[59].

Since direct taxation falls within the competence of the EU Member States, the EU institutions do not have any taxing power over direct taxes[60]. Therefore, the Council of the EU may issue directives affecting direct taxes only in accordance with Article 115 of the TFEU requiring unanimity of the EU Member States. Due to the strict requirement, the EU has issued only four directives having an impact on direct taxes. These directives are the

[52] The competence on internal market is shared competence with pre-emption, meaning that both the EU and the EU Member States are competent to regulate tax matters in the field of internal market. However, when the EU exercises its competence to regulate a certain tax matter, the EU Member States lose their competence in the area of such tax matter, pursuant to Article 4(2)(a) of the TFEU and Protocol No. 25 of the TFEU. See more in Terra – Wattel 2019, p. 11.
[53] Article 26(2) of the TFEU.
[54] Specific articles of the TFEU together with Article 26 of the TFEU constitute the whole legal basis for each of the basic freedoms. For instance, the basic freedom granting the free movement of persons entails a freedom of establishment granted by Article 49 of the TFEU. Under Article 26 of the TFEU, capital and payments must also be able to move freely within the internal market of the EU. Their legal basis is, in turn, provided by Article 63 of the TFEU together with the above-mentioned article. See more about the legal basis of the other basic freedoms in Malmgrén – Myrsky 2017, pp. 143–154; and Terra Wattel 2019, pp. 61–86.
[55] Terra – Wattel 2019, pp. 8, 46.
[56] Terra – Wattel 2019, p. 5.
[57] See Article 113 of the TFEU. See also Terra – Wattel 2019, pp. 9, 11–12.
[58] This viewpoint has been challenged as direct taxes are included in the prices of goods and services exported by economic operators, but not refunded upon exportation like indirect taxes. Therefore, one may argue that direct taxes also are tax obstacles to the free trade of goods and services. See Terra – Wattel 2019, p. 5.
[59] See Articles 3, 4, 5, and 6 of the TFEU. For a comprehensive analysis on the contemporary meaning and significance of the concept '*sovereignty*' within the EU, see Isenbaert 2009. See also Bizioli 2008, pp. 133–140; and Helminen 2018, p. 25.
[60] Helminen 2018, p. 25; and Terra – Wattel 2019, p. 12.

Parent-Subsidiary Directive on Dividends, Merger Directive, Interest-Royalties Directive, and Anti-Tax-Avoidance Directive. Additionally, the Administrative Cooperation Directive and Recovery Directive are relevant for direct taxation.[61]

With regard to the hierarchical position of EU law, EU law provisions take precedence over conflicting domestic tax law provisions regardless of the status or age of the domestic provisions[62]. The primacy of EU law precludes both the enactment of conflicting domestic tax law provisions and conclusion of conflicting tax treaties, as well as the application of such statutes[63]. If there are conflicting provisions, they have to be amended or abolished in order to comply with EU law[64]. As a conclusion, all EU Member States are obliged to apply domestic tax law and tax treaty provisions in accordance with EU law.

1.4.3 Interpretation of Treaty Terms

Although the interpretation of international tax law provisions follows similar principles as the interpretation of domestic tax law provisions, the dualistic status leads to the application of different rules in the interpretation of tax treaty terms[65]. Since tax treaties are international treaties, they are governed by the interpretation rules of customary international law[66]. The most important interpretation rules for tax treaties are included in Articles 31 and 32 of the VCLT. First and foremost, the contracting states are required to interpret a tax treaty in good faith in accordance with the ordinary meaning to be given to the tax treaty terms in their context[67] and in the light of its object and purpose[68]. This means that priority is given to the

[61] See Helminen 2018, pp. 40–41.
[62] The ECJ has given the priority to EU law over the EU Member States' national laws in its case law already in 1964. See Case C-6/64 Costa v ENEL. In the context of the basic freedoms, see, e.g., Case C-279/93, Schumacker, point 21; Case C-446/03, Marks & Spencer, point 29; and Case C-196/04, Cadbury Schweppes and Cadbury Schweppes Overseas, point 40. The primacy of EU law over the Finnish domestic laws has been confirmed by the SAC in SAC 1996 T 2617.
[63] See, e.g., C-286/86 Deserbais; and C-235/87 Matteucci. See also Nykänen 2015, pp. 50–53; Malmgrén – Myrsky, pp. 130–131; and Helminen 2018, p. 28.
[64] For the sake of legal certainty, the conflicting provisions must be amended or abolished even if the provisions are not applied in practice. See, e.g., C-358/98 Commission v Italy, points 16 and 17; C-160/99 Commission v France, point 22; and C-522/04 Commission v Belgium, point 70. See also Helminen 2018, p. 29.
[65] Helminen 2018, Fundamentals of International Tax Law, Interpretation of International Tax Law Provision, Tax Treaty Interpretation.
[66] The VCLT is commonly used as guidance for tax treaty interpretation also in states that have not ratified the convention. See Rohatgi 2007, p. 27; and Vogel 2015, p. 24.
[67] Article 31(2) of the VCLT stipulates that the context is narrowed to only include rest of the tax treaty and documents related thereto.
[68] Article 31(1) of the VCLT.

ordinary meaning of the written treaty terms[69]. One should note that the object and purpose of the treaty may be used as subordinated sources for interpretation of the terms but not as independent means of interpretation. However, the intention of the contracting states may be used as an independent means of interpretation if it is supported by the wording of the tax treaty.[70] Moreover, one should take into account that all language versions are equally binding unless otherwise agreed[71].

Supplementary means of interpretation, such as preparatory works, may be used as a secondary source to confirm the interpretation resulting from the wording and intention of the parties or as an independent support for interpretation in cases of doubt[72]. The SAC has held that the OECD Model and its official commentaries are the most important source for interpretation of tax treaties after the wording of tax treaties[73]. Many of Finland's tax treaties include a reference to the meaning of the term under domestic laws[74]. In this case, the domestic law definition has great relevance in tax treaty interpretation as it determines the meaning of the treaty term[75].

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[69] The ordinary meaning of treaty terms might differ from the everyday language as it means the uniform legal language, such as international tax language, or the specific legal language applied by the contracting states. See more, e.g., in Rohatgi 2007, pp. 40–42; Vogel 2015, p. 39; Nykänen 2015, pp. 41–42; and Parada 2018, pp. 55–59; and Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Interpretation of International Tax Law Provision, Tax Treaty Interpretation.

[70] Vogel 2015, p. 39.

[71] Article 33 of the VCLT. See Vogel 2015, p. 40.

[72] Article 32 of the VCLT. See, e.g., Nieminen 2014, p. 94; and Vogel 2015, p. 40. *Rohatgi* clarifies that such other relevant material, including international legal practice, other tax conventions, judicial decisions, and legal writings, must represent the reasons and goals of all contracting parties, and thus unilateral material should not be regarded as a supplementary means of interpretation in the manner intended in Article 32 of the VCLT. See Rohatgi 2007, p. 42.

[73] See, e.g., SAC 2002 T 596; and SAC 2013:169. The common view is that only the OECD Model and its commentaries at the time of the conclusion of a tax treaty can be used as other supplementary means for interpretation purposes. This standpoint is logical as only they were in the use of tax treaty negotiators at the time of the conclusion of the tax treaty. See Vogel 2015, p. 48; and Parada 2018, pp. 65–66. Cf. OECD 1997.

[74] The application of Article 3(2) of the OECD Model has raised a question whether the reference to domestic law is to the legislation in force when the tax treaty was signed (*static interpretation*) or to the legislation in force at the moment of the application of the treaty (*ambulatory interpretation*). The Committee on Fiscal Affairs concluded that the ambulatory interpretation should prevail as states should not be allowed to make a tax treaty partially inoperative by amending in its domestic law the terms that were not defined in the tax treaty. This standpoint was also adopted to the OECD Model in 1995. See paragraphs 11 to 13 of the Commentary on Article 3 of the OECD Model 2017.

[75] Vogel 2015, pp. 44–45; and Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Interpretation of International Tax Law Provisions, Tax Treaty Interpretation. In this context, one should note that a reference to domestic laws may increase the risk that the contracting states interpret the treaty terms in a different manner. Consequently, the interpretation of the terms should always be primarily based on the available supplementary means of interpretation. See SAC 2004:116. See more in Nykänen 2015, pp. 42–43.

1.5 Outline of the Study

A holistic examination of the research questions presented in Subchapter 1.2 requires a comprehensive overview of all relevant regulations and their objectives. In order to answer the research questions, the reader should have knowledge on the functioning of Finnish private equity funds. To this end, Chapter 2 introduces a typical legal structure and certain special characteristics of Finnish private equity funds. In addition, the second part of the study explores private law aspects related to Finnish private equity funds for the purpose of establishing a solid framework for the study. However, the main objective of Chapter 2 is to analyse the tax treatment of Finnish private equity funds in Finland.

Chapter 3 focuses on examining the tax treatment of foreign investors in Finnish private equity funds. The aim is to familiarise the reader with the Finnish international tax environment into which foreign investors enter at the moment they invest in Finnish private equity funds. Firstly, the third part of the study deals with general rules governing the tax treatment of foreign investors in Finland. Secondly, the effects of tax treaties are shortly examined. Thirdly, Chapter 3 introduces the special tax regime governing the tax treatment of foreign investors in Finnish private equity funds. This part of the study ends with an analysis on the tax assessment of foreign investors in Finland.

Chapter 4 is devoted to an extensive analysis on the application of the special provisions to foreign investors in Finnish private equity funds. The analysis is made from the perspective of both direct and indirect investments in Finnish private equity funds. At first, the conditions for applying the special provisions are introduced. After the brief introduction, the focus shifts to dealing with the core issues of this study: the conditions that have to be met on each level of the fund structure for the purpose of applying the special tax regime. Furthermore, the fourth part of the study provides a fundamental analysis on the main concerns regarding the application of the special provisions.

Finally, Chapter 5 summarises the main findings of the study. In addition, the last part of the study presents some concluding remarks and *de lege ferenda* analysis regarding the tax treatment of foreign investors in Finnish private equity funds.

2 FINNISH PRIVATE EQUITY FUNDS

2.1 Introduction

Private equity activities usually refer to fixed-term investments in mainly non-listed companies that have great development potential. The intention of private equity investors is not to passively hold their shares in portfolio companies for an infinite period, but to realise the investments after a pre-determined time period, which seldom is more than ten years[76].[77] During the ownership period, private equity investors aim to grow the business and increase the profitability of their portfolio companies by, for instance, administrating and developing the companies as well as providing their networks for the use of the companies[78].

At the end of the ownership period, private equity investors realise their investments in their portfolio companies (also referred to as an *exit*). Exits are usually carried out by listing the shares in the companies (also referred to as an *initial public offering* or *IPO*) or selling the shares to either industrial buyers (also referred to as a *trade sale*) or to other private equity investors (also referred to as a *secondary sale*). Alternatively, private equity investors may end up liquidating the portfolio companies.[79]

Private equity investors often make investments in portfolio companies through a collective investment vehicle, in other words a fund[80]. A Finnish fund may be established in the legal form of a limited partnership, limited liability company, or Finnish investment fund, including a special investment fund[81]. Funds operating in the private equity sector are

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[76] Usually, the term of Finnish private equity funds is ten years, but it is often extended by some years. See, e.g, Government Proposal 17/2015 vp, p. 11. One should note that Finnish private equity funds may also be established for a longer period of time. Some funds might even have a term of indefinite duration (also referred to as *evergreen funds*). See Laininen 2017 for a thorough analysis on the regulative environment of evergreen funds in Finland.

[77] See, e.g., Hidén – Tähtinen 2005, p. 15; Lehtimaja 2006, p. 43; Lauriala 2008, pp. 148–149; and Järvenoja 2013, p. 323.

[78] See Lauriala 2004, p. 22; and Hidén – Tähtinen 2005, pp. 16, 299. Private equity investors investing in start-ups and other early stage companies may sometimes be even more hands-on as they might assist the companies in setting up their organisation, recruiting, and going through their research and development processes. See Demaria 2013, p. 240.

[79] For a more throughout analysis on the different exit strategies, see Lauriala 2004, pp. 199–214; Hidén – Tähtinen 2005, pp. 308–315; and Walker 2016. Currently, the global trend seems to be that private equity investments are more often realised by selling the shares in portfolio companies to either strategic buyers, such as large corporations looking to acquire growth, or other private equity firms willing to shepherd the companies to a new level of performance. Interview with Santavirta 2019. See more about the latest trend in Finland in Press release of the FVCA 2019c.

[80] See Lauriala 2004, pp. 34–36; and Hidén – Tähtinen 2005, pp. 18–26.

[81] The use of a Finnish investment fund differs from the use of limited partnerships and limited liability companies with respect to its activities that are restricted to activities specified in the Investment Fund Act. Due to presentational reasons, a further analysis on the other legal forms available is not provided in this thesis. See more about the other legal forms in Viitala 2018, pp. 528–546.

referred to as private equity funds[82]. For the purpose of establishing a solid framework for the study, this Chapter 2 starts with an introduction of a typical legal structure and certain special characteristics of Finnish private equity funds. After this, the focus shifts to dealing with Finnish laws governing the functioning and taxation of Finnish private equity funds.

2.2 Legal Structure of Finnish Private Equity Funds

This Subchapter 2.2 provides an overview on the typical legal structure of Finnish private equity funds. In Finland, there is no specific legal form designed for private equity activities. Consequently, the Finnish private equity sector has developed its own private equity industry standards.[83] From a legal perspective, the most relevant questions related to the establishment of investment funds concern their legal form, interpretation of regulation in question, and taxation. The legal forms available for collective investments depend on private law rules imposed on different legal entity forms and rules regulating investment fund activities. In general, investment funds are established in a legal form that allows the separation of assets related to the collective investment activities from assets of investors and fund managers.[84]

Finnish private equity funds are typically structured in a way that the fund is established as a limited partnership (*kommandiittiyhtiö* in Finnish)[85]. A standard limited partnership fund has one general partner and several limited partners. The partners may be individuals or legal persons residing either in Finland or abroad[86]. A simplified private equity fund structure is illustrated below in Figure 1. Even if some Finnish private equity funds may be structured this simply, issues related to, for instance, profit distribution may require more complicated

[82] Private equity funds have specific characteristics distinguishing them from other investment funds. Firstly, private equity funds differ in respect of their fixed lifetime and nature as closed-end funds. Secondly, shares in private equity funds are relatively illiquid assets due to the fact that they are not typically intended to be traded or sometimes even transferred. Thirdly, private equity fund investments require substantial initial commitments from investors. Consequently, the investor base of private equity funds mainly comprises institutional investors and other large-scale investors. See Lauriala 2004, pp. 23, 35; and Hidén – Tähtinen 2005, pp. 19–21.
[83] See, e.g., Lauriala 2004, p. 33–36; Hidén – Tähtinen 2005, pp. 39–43; and Viitala 2007, p. 5.
[84] See Viitala 2018, p. 528.
[85] See, e.g., Government Proposal 306/2018 vp, p. 3. This statement was confirmed to be correct and accurate by *Santavirta* in June 2019. Interview with Santavirta 2019. It is not only a Finnish trend to establish private equity funds in the legal form of limited partnerships as it is also the most popular legal form in the international private equity fund context. Many states have similar legal forms to a Finnish limited partnership, such as an English or American *limited partnership*, Swedish *kommanditbolag*, German *Kommanditgesellschaft*, Dutch *commanditaire vennootschap*, French *fonds commun de placement à risques* (also referred to as *FCPR*), and Luxembourg *fonds commun de placement* (also referred to as *FCP*). See Hidén – Tähtinen 2005, pp. 40–41; Viitala 2007, pp. 17–28; and Järvenoja 2013, p. 46. See also Government Proposal 306/2018 vp, p. 8.
[86] Government Proposal 256/1994 vp, p. 3.

fund structures. However, private equity funds are usually established in limited partnership form also in these more complicated fund structures.[87]

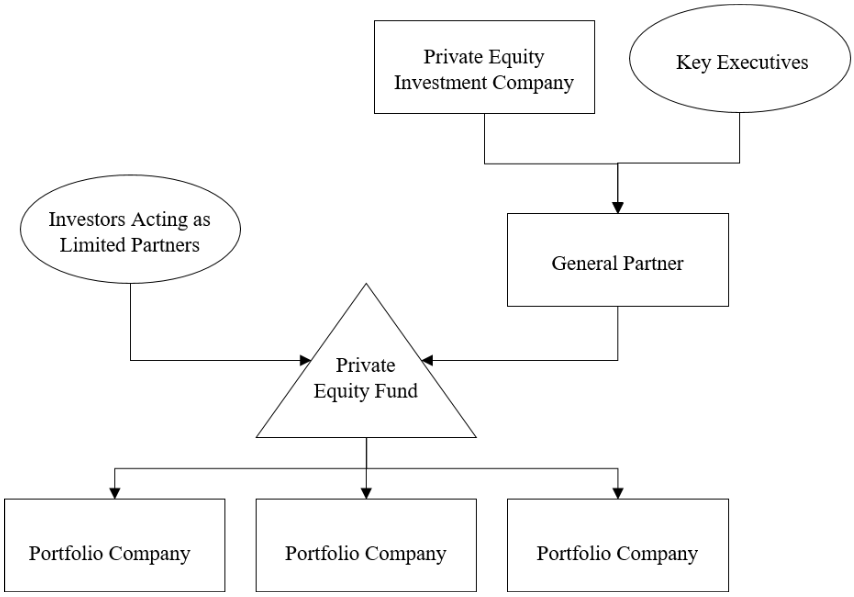

Figure 1: A typical private equity fund structure

The role of the general partner in a Finnish private equity fund is to take care of the management of the fund's activities[88]. Instead of acting as the general partner of the fund, private equity investment companies, sometimes together with their key executives, establish a separate limited liability company for this specific purpose (also referred to as a *special purpose vehicle*)[89]. Limited partners are often referred to as investors of the fund. In general, the investor base of Finnish private equity funds consists of institutional investors, such as pension insurers, banks, and insurance companies, as well as other large-scale investors, such as different kinds of funds, public operators, and large or medium-large companies and their holding companies[90]. Even though investors may also be individuals, the financially most significant investments are often made by institutional investors and other large-scale investors[91].

In judicial literature, several reasons have been presented for the popularity of the use of a limited partnership structure among private equity investors[92]. Firstly, the use of a limited

[87] See Hidén – Tähtinen 2005, p. 41.
[88] See Government Proposal 306/2018 vp, p. 3. See also Hidén – Tähtinen 2005, p. 39.
[89] Shares are sometimes also allocated to the key executives due to issues related to their compensation arrangements and spreading of risk. See Hidén – Tähtinen 2005, p. 42; and Sääski Keskitalo 2015, p. 63.
[90] See Government Proposal 306/2018 vp, p. 5. See also, e.g., Lauriala 2004, pp. 34–36; and Hidén – Tähtinen 2005, pp. 19, 39–43.
[91] See Hidén – Tähtinen 2005, p. 19.
[92] See, e.g., Wilhelmsson – Jääskeläinen 2001, pp. 6–7; Hidén – Tähtinen 2005, pp. 40, 46; Passinen 2007, pp. 135–142; Järvenoja 2013, pp. 46, 326; and Viitala 2018, pp. 530–531, 533.

partnership allows flexible governance structures. Secondly, a limited partnership enables to both invest and restore capital in a flexible way. Thirdly, a limited partnership is considered as an ideal investment vehicle because it is transparent for tax purposes. This means that there is no additional layer of tax at the fund level as income is always taxed solely in the hands of the partners.[93] These special characteristics of Finnish private equity funds formed as limited partnerships are further analysed from both private law and tax law perspectives in the following subchapters.

2.3 Finnish Private Equity Funds as Investment Vehicles

2.3.1 Finnish Private Equity Funds in Private Law

For the purpose of establishing a solid framework for the study, this Section 2.3.1 briefly covers the private law provisions governing the governance, fundraising, and profit distribution of Finnish private equity funds. First and foremost, Finnish private equity funds formed as limited partnerships are governed by the Partnership Act. The application of the provisions of the law is, however, discretionary to a large extent. Consequently, also general contractual rules regulate the functioning of Finnish private equity funds.

To start with, the statutory definition of limited partnerships is included in Section 1 of Chapter 1 of the Partnership Act. The provision stipulates that a limited partnership must have at least two partners[94] who jointly carry on business activities on the basis of a partnership agreement (*yhtiösopimus* in Finnish). In a limited partnership, there should be, at least, one general partner who is personally liable for the debts and obligations of the partnership as if they were its own (*vastuunalainen yhtiömies* in Finnish)[95] and one limited partner whose liability is limited to the amount of such partner's capital contribution agreed upon in the partnership agreement (*äänetön yhtiömies* in Finnish)[96].

[93] Hidén – Tähtinen 2005, pp. 40, 46; Passinen 2007, pp. 135–142; Järvenoja 2013, p. 326; and Viitala 2018, pp. 530–531, 533.
[94] Pursuant to Section 9(1) of Chapter 5 of the Partnership Act, if the number of partners is lowered to one and does not rise to two or more within one year, the partnership is regarded to be dissolved after a fixed time has elapsed. Based on the wording of the law, there are no prerequisites for the legal form or number of partners. See in general, e.g., Wilhelmsson and Jääskeläinen; 2001, pp. 40–41; Toiviainen 2008, p. 268; and Villa – Tarasti 2018, pp. 100–111.
[95] Section 1(2) of Chapter 1 of the Partnership Act.
[96] Sections 1(2) and 1(3) of Chapter 1 of the Partnership Act. See also Section 6 of Chapter 7 of the Partnership Act.

For the purpose of establishing a Finnish private equity fund in the legal form of a limited partnership, partners have to conclude a partnership agreement. The agreement[97] must be enclosed with a start-up notification to the Trade Register in Finland as a partnership is considered to be formed upon a registration of a partnership agreement with the Finnish Trade Register[98]. The Finnish Trade Register demands that the following details are specified in the partnership agreement: the name of the partnership, all partners and their types, line of business, place of registered office, amount in euro of the contribution made by each limited partner, and general partner(s) authorised to represent the partnership[99].

Since partners are not required to include all relevant aspects of a Finnish private equity fund in the partnership agreement, they usually conclude a separate limited partnership agreement (*osakassopimus* in Finnish)[100] in which they may agree on, inter alia, their mutual relations, decision-making, profit distribution, and disposal of shares in the partnership[101]. Due to the fact that the application of the provisions of the Partnership Act is broadly discretionary, partners may set aside many of the default provisions by agreeing otherwise. Consequently, partners of a limited partnership have a broad freedom to contract. This enables them to arrange their business in a manner that suits them best.[102]

In addition to the unlimited liability for debts and obligations, the general partner is responsible for the management of the fund[103]. However, in practice most of Finnish private equity funds are not managed by the general partner, but by a separate fund manager (also referred to as *the management company*[104]) appointed by the general partner in a management

[97] A partnership agreement must be in a written form and dated as well as signed by all the partners. See Government Proposal 17/2015 vp, pp. 20–21, 23.
[98] Section 2 of Chapter 1 of Partnership Act. Previously, a limited partnership was considered to exist already when partners had reached a necessary unanimity. Hence, neither a partnership agreement nor a registration was needed in order to form a limited partnership. However, the previous provision raised many problems of interpretation, some of which have also been subject to court proceedings. See, e.g., KKO 1966 II 99; KKO 1977 II 86; and KKO 1995:155. For the sake of clarity and legal certainty, the law was amended in 2015. See more Government Proposal 17/2015 vp, pp. 4, 14–15. See also, e.g., Engblom *et al.* 2018, p. 73.
[99] Section 6 of the Trade Register Act. If the partnership agreement is amended, the amended partnership agreement will have to be submitted to the Finnish Trade Register in order for the new provisions to be binding towards third parties. See Engblom *et al.* 2018, p. 81.
[100] The conclusion of two separate agreements has some advantages. Due to the fact that the limited partnership agreement does not have to be registered in the Finnish Trade Register, information therein is not publicly available. Moreover, possible amendments to the agreement are not required to be submitted to the Finnish Trade Register. Furthermore, the formal language requirements, Finnish and Swedish, of the partnership agreement are not relevant for the limited partnership agreement. Therefore, the limited partnership agreement may also be concluded, for instance, in English. See Hidén – Tähtinen 2005, p. 52.
[101] Lauriala 2004, pp. 159–165; Hidén – Tähtinen 2005, p. 245; and Järvenoja 2013, p. 329.
[102] Lauriala 2004, p. 40; and Hidén – Tähtinen 2005, pp. 52–54.
[103] Järvenoja 2013, p. 47.
[104] For more information on the role of the management companies in Finnish private equity funds, see Lauriala 2008, pp. 157–158.

agreement (*rahastosopimus* or *hallinnointisopimus* in Finnish)[105]. Despite the appointment of a separate fund manager, the general partner retains the right to terminate the term of the fund manager and appoint a new fund manager. Thus, the general partner maintains the final decision-making rights concerning the management of the fund.[106] Limited partners do not, in principle, participate in the management of the fund's affairs[107].

As of the year 2014, the management of Finnish private equity funds has no longer been solely governed by the Partnership Act and general contractual rules as the Finnish private equity industry has been affected by the AIFM Act[108]. The AIFM Act regulates, inter alia, the obligation of the alternative investment fund managers to obtain an authorisation to provide investment services and sets requirements regarding equity, management of liquidity and liquidity risk, and valuation. In addition, the law imposes reporting obligations on the alternative investment fund managers and conditions for marketing alternative investment funds. Since a great number of Finnish private equity funds fall into the scope of application of the AIFM Act[109], many fund managers are obliged to follow the new regulation in the management process.

2.3.2 Finnish Private Equity Funds in Tax Law

Besides rules regulating the choice of the most appropriate legal form for investment activities, investors often pay great attention to tax aspects related to the potential legal forms. In an ideal situation for investors, investments made through investment funds do not cause any extra tax costs, and taxation takes place either at the investor level or at the fund level.[110] Finnish private equity funds formed as limited partnerships are treated as business partnerships (*elinkeinoyhtymä* in Finnish) under Section 4(1) of the ITA.

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[105] Hidén – Tähtinen 2005, p. 45; and Passinen 2007, p. 29.
[106] Passinen 2007, p. 29.
[107] Limited partners may, however, be entitled to contribute in the decision-making process via an advisory committee. See more, e.g., in Hidén – Tähtinen 2005, p. 133; Passinen 2007, p. 252; Lauriala 2008, p. 157; and Järvenoja 2013, pp. 47, 326. See also Government Proposal 6/1987 vp, pp. 57–58. Since the success of the investments depends on the investment decisions and executions, limited partners often want to commit the personnel of the management company to the fund by including so called *keyman clauses* in the fund's contractual terms. The purpose of the keyman clauses is to govern the changes in personnel of the management company. See more, e.g., in Lauriala 2004, pp. 44–47; and Hidén – Tähtinen 2005, pp. 127–129.
[108] The AIFM Act is based on the AIFM Directive that entered into force in Finland on 15 March 2014. After the lapse of the transitional period on 22 July 2014, marketing of alternative investment funds to Finnish investors has been subject to local authorisation or registration by or, as regards foreign legal entities, notification to the Finnish Financial Supervisory Authority. See Government Proposal 94/2013, vp.
[109] Government Proposal 94/2013 vp, p. 104; Government Proposal 17/2015 vp, p. 10; and Government Proposal 306/2018 vp, p. 3. See also Järvinen 2019, p. 182.
[110] See, e.g., Viitala 2018, p. 529.

In the systematics of Finnish tax legislation, business partnerships function as accounting units to whom the total amount of income is computed. Following the computation, the total amount of income is allocated to the partners[111] in proportion to their shares in the partnerships' income after deducting tax losses from preceding fiscal years.[112] In other words, Finnish private equity funds treated as business partnerships are not considered as separate tax subjects for Finnish tax purposes as income received by them is solely taxed in the hands of their partners[113].

Since Finnish private equity funds are disregarded for Finnish tax purposes, they are considered to be fiscally transparent. The fiscal transparency of Finnish private equity funds means that investments through such funds do not usually incur any extra tax costs for investors compared to direct investments. The fiscal transparency is crucial especially for non-resident investors as it enables single taxation not only in purely domestic situations, but also in cross-border situations.[114] In conclusion, the flow-through tax treatment of income received through Finnish private equity funds also speaks for the legal form of a limited partnership.

2.3.3 Fundraising and Profit Distribution

Partners of Finnish private equity funds formed as limited partnerships may flexibly agree on both fundraising and profit distribution of the funds[115]. Aspects on profit distribution are further analysed after giving a brief introduction to the fundraising process of Finnish private equity funds. Since the purpose of private equity funds is not to hold investors' capital needlessly, the funds call for capital only when it is needed for investments or payments of expenses and compensations[116]. In practice, each limited partner gives the fund a capital commitment[117] specifying the maximum amount they will commit to the fund during its lifespan as well as the conditions under which the general partner may call a portion of the

[111] Since Section 16 of the ITA does not make a difference between the tax treatment of limited partners and the tax treatment of the general partner, the same rules are applied to all partners. See, however, Section 58(7) of the ITA.
[112] Subsections 16(1) and (2) of the ITA. See Government Proposal 200/1992 vp, p. 30.
[113] Section 16 of the ITA. See, e.g., Viitala 2018, p. 533; Villa – Ossa 2017, p. 147; and Helminen 2018, Forms of Doing Business and Business Profits, Partnerships, Tax Treatment of Partnerships, Treatment under Finnish tax law.
[114] See Viitala 2018, p. 533.
[115] Discretionary provisions on profit distribution are included in Sections 1 and 4 of Chapter 2 and Sections 2 and 4 of Chapter 7 of the Partnership Act.
[116] Hidén – Tähtinen 2005, p. 95; and Järvenoja 2013, p. 327.
[117] The capital commitments usually represent the capital contributed by limited partners that is agreed upon the partnership agreement. See Hidén – Tähtinen 2005, pp. 120–124.

commitment to the fund. When the fund needs capital for investments or above-mentioned payments, the general partner presents the limited partners a capital call in the form of a drawdown notice, whereupon limited partners are required to make payments to the fund.[118]

With regard to profit distribution of private equity funds, it is worth noting that private equity funds are typically loss making during the investment period, which lasts approximately four to five years. This is due to the fact that the funds start generating revenue usually only after disposing of shares in portfolio companies, but they have to cover all expenses related to the management of the fund, including so called *management fees* paid to the general partner[119], and investments in the meantime. The cash flow profile of private equity funds is often referred to as *the J-curve*, because the shape of the line representing the cash flow vaguely resembles the letter '*J*' when drawn on a grid. Since the performance of the funds may vary greatly from year to year, the actual success of investments may be determined only at the end of the realisation phase when all investments have been liquidated.[120]

Partners of private equity funds usually agree in detail on the profit distribution principles[121]. In comparison to a limited liability company, a limited partnership has a less strict capital structure, and thus its profits may be transferred without being subject to credit protection provisions or a formal distribution resolution[122]. A standard profit distribution model of a private equity fund (also referred to as *the waterfall*) comprises capital repayments to limited partners and profit distribution payments to the general partner and limited partners[123]. The profit distribution principles agreed between partners usually concern all cash flow of the fund as a cumulative whole, meaning that the profit sharing calculations have to be reviewed in connection with every capital payment in and profit distribution out of the fund[124].

[118] Lauriala 2004, p. 36; and Hidén – Tähtinen 2005, pp. 96–97.
[119] The general partner is generally compensated for the management services it provides for the fund. The payments are referred to as management fees. The main purpose of management fees is to cover all costs related to the management of the fund, including running costs, salaries, and advisory costs. The amount of management fees is usually a fixed percentage of the total amount of capital commitments or capital actually invested in the fund. See more in Hidén – Tähtinen 2005, pp. 124–126; Passinen 2007, pp. 119–120; and Lauriala 2008, p. 160.
[120] Hidén – Tähtinen 2005, pp. 97–98, 132; and Lauriala 2008, p. 163. See more about measuring the performance of private equity funds in Demaria 2013, pp. 99–110.
[121] Järvenoja 2013, p. 327. Unless otherwise agreed between the partners, the distribution of profits and allocation of losses follow rules laid down in Section 4 of Chapter 7 of the Partnership Act.
[122] Immonen – Ossa – Villa 2012, p. 62.
[123] If the general partner has injected capital into the fund, it is in the same position as limited partners in that regard. See Hidén – Tähtinen 2005, pp. 39, 99–108; and Järvenoja 2013, p. 326.
[124] Hidén – Tähtinen 2005, p. 99; and Järvenoja 2013, pp. 327–328.

In general, capital repayments are agreed to be made before actual profit distribution payments. Capital repayments are usually allocated to limited partners *pro rata* with the total amount of their capital payments.[125] In addition to receiving the capital repayments, the limited partners usually receive interest, which is called *the hurdle rate* or *preferred return*, for their capital payments from the time period during which the capital has been invested in portfolio companies or has otherwise been in the possession of the fund[126]. After the payment of possible hurdle rates, the remaining profits are divided between the limited partners and general partner as agreed in their mutual agreement. The profit share of the general partner is called *carried interest*, and it usually amounts up to 20 to 25% of the profits of the fund. The remaining profits are distributed to limited partners in proportion to their capital payments in the fund.[127]

2.4 Calculation of Taxable Income

2.4.1 Profit Distribution and Taxation

Before addressing the actual calculation of taxable income derived through Finnish private equity funds, it is essential to clarify the relation between profit distribution and taxation. In this context, a profit share (*voitto-osuus* in Finnish) has to be clearly distinguished from an income share (*tulo-osuus* in Finnish). The former refers to the amount of income to which the partners are entitled on the basis of the limited partnership agreement, whereas the latter refers to the partners' share of the taxable income that has been confirmed to the partnership[128]. In Finland, tax is levied only on the income share, meaning that the profit share received by the partners is not taxed at the moment of the actual profit distribution payments[129].

The allocation of profits of Finnish private equity funds is generally based on the profit distribution provision of the limited partnership agreement[130]. Taxation of income derived through limited partnerships is carried out in accordance with information provided in filed

125 Hidén – Tähtinen 2005, pp. 100–104; and Järvenoja 2013, p. 328.
126 Hidén – Tähtinen 2005, p. 100; and Järvenoja 2013, p. 327.
127 Hidén – Tähtinen 2005, p. 101; Passinen 2007, pp. 120–122; Lauriala 2008, pp. 157, 162–163; and Järvenoja 2013, pp. 328–329.
128 See, e.g., Villa – Ossa 2017, pp. 147–148.
129 Section 6(1)(4) of the BITA. See also Immonen – Ossa – Villa 2012, p. 73; and Tikka *et al.* 2014, p. 213.
130 See Vilppula 2005, p. 166; Juusela 2007, p. 96; and Viitala 2018, p. 533. Based on the preparatory works of the Partnership Act, partners' income share in limited partnerships is generally determined on the basis of the partnership agreement when the partners are entitled to equal shares to the income of the partnerships. However, the wording of the bill is obviously outdated because it is no longer common that partners of limited partnerships have equal profit shares. See Government Proposal 200/1992 vp, p. 31.

tax returns[131]. The limited partnerships and their partners whose income is subject to a regular tax assessment have to file their own income tax returns showing their taxable income[132]. If the profit shares are based on the limited partnership agreement and distribution provision is amended during the course of the tax year, the amended agreement should be attached to the tax return[133].

The starting point of the Finnish tax legislation is that the income share of each partner is equal to their profit share agreed in the limited partnership agreement[134]. This may cause certain practical problems in respect of Finnish private equity funds as their profit distribution provisions are usually based on the funds' cumulative cash flow instead of the pre-agreed distribution of profits[135]. As noted in Section 2.3.3, after paying a management fee to the general partner, the fund pays out the capital repayments with the hurdle rate to the limited partners. Finally, the rest of the cash flow is divided between the general partner and limited partners as agreed in the limited partnership agreement.[136]

Since Finnish private equity funds intend not to hold their partners' capital needlessly, they normally distribute their profits to the partners as soon as they can. However, the partners may be obliged to return a part of the profits received from the fund by virtue of so called *claw back clauses*[137]. As the partners are taxed on their income shares on an annual basis, the changes in the profit allocation may lead to a situation where the taxation is not correctly

[131] See, e.g., Vilppula 2005, p. 170; and Engblom *et al.* 2018, p. 81.

[132] See Guidance of the FTA A123/200/2016; and Government Proposal 306/2018 vp, p. 18. The general partner is ultimately responsible for fulfilling the obligation to file the income tax return of the partnership as it is responsible for the debts and obligations of the fund under the Partnership Act.

[133] See Engblom *et al.* 2018, p. 81; and Tikka *et al.* 2019, Chapter 5, Eri yritysmuotojen verotusasema, Henkilöyhtiöt, Osakkaiden tulo-osuudet, Voitonjakomääräysten muuttaminen.

[134] Government Proposal 200/1992 vp, p. 10. See Vilppula 2005, p. 170; Järvenoja 2013, p. 236; Andersson – Linnakangas – Frände 2016, p. 34; Villa – Ossa 2017, p. 148; and Tikka *et al.* 2019, Chapter 5, Eri yritysmuotojen verotusasema, Henkilöyhtiöt, Osakkaiden tulo-osuudet.

[135] See Vilppula 2005, pp. 172–173; and Lehtimaja 2006, pp. 48–49.

[136] It is interesting to note that the relation between capital repayments and profit distribution payments has not been the centre of attention in Finland. As observed, the funds pay first the full amount of capital repayments before profit distribution payments. In reality, capital repayments do not *de facto* solely consist of capital reimbursements. Instead, they also comprise income items, such as proceeds from share disposals, dividends, and interest, as some of the partners' capital payments are still invested in the portfolio companies. One could argue that the taxation should be assessed by taking into account the actual nature of the funds' profits. Without going into greater details, the change could affect the taxation of investors in Finnish private equity funds as the timing of their taxation, and in respect of individuals possibly also the tax rate, might change.

[137] The limited partner claw back clause may actualise, for instance, in connection with an adjustment of profit distribution or third party claim for damages. See Lehtimaja 2006, p. 48; and Lauriala 2008, p. 164. The general partner may also be obliged to return a part of its profits to the fund when the agreement includes a claw back clause covering the general partner. See more in Vilppula 2005, pp. 108–111, 173; and Lauriala 2008, pp. 163–164.

assessed as the partners' tax burdens are not in proportion with their eventual profit shares[138]. For instance, if the limited partners are obliged to return profits that have already been taxed in their hands and the profits are then distributed to the general partner, the taxation has obviously not taken place in the correct hands.

The taxation may also be incorrectly assessed due to the uncertainty related to the final amount[139] and tax treatment of the general partner's carried interest[140]. If carried interest is treated as an item of profit distribution but is confirmed only after the tax assessment, the limited partners might be subject to a heavier tax burden than they should on the basis of the actually distributed profits. In other words, they have been taxed for a greater amount than what they have actually received through the fund. This mismatch could be avoided by informing the tax authorities about the general partner's right to carried interest.[141] Even though the limited partners may ask for a refund from the FTA, the three-year time-limit might prevent them from recovering the excess tax[142].

If carried interest is, in turn, treated as an expense, it will be tax-deductible from the taxable income computed at the fund level. Since the final amount of carried interest is only determined at the end of the partnership period, it is possible that there is no taxable income from where it could be deducted. Under these circumstances, it is possible that the deduction cannot be used at all because the partnership's losses cannot be passed through to the partners.[143] Hence, the determination of the nature of carried interest is also in the interest of foreign investors acting as limited partners in Finnish private equity funds.

2.4.2 Income Subject to Tax

The cash inflow of Finnish private equity funds generally comprises mainly capital payments from partners and proceeds from the disposals of shares in portfolio companies[144]. Additionally, the funds may receive other income, such as interest and dividends, from their

[138] See Lehtimaja 2006, p. 48.
[139] The uncertainty related to the final amount of carried interest stems from the fact that the final amount of carried interest is determined only at the end of the partnership period when all assets have been liquidated and other payments paid. See Vilppula 2005, p. 171; and Järvenoja 2013, p. 351.
[140] Vilppula 2005, pp. 171–174; and Järvenoja 2013, pp. 351–353.
[141] Vilppula 2005, p. 172; and Järvenoja 2013, p. 351.
[142] Section 11 of the Act on Taxation of Non-residents. See Järvenoja 2013, p. 352.
[143] See more in Vilppula 2005, pp. 173–174; and Järvenoja 2013, p. 352.
[144] Government Proposal 92/2004 vp, pp. 34–35. In June 2019, *Santavirta* confirmed that Finnish private equity funds seldom receive any dividend income from their portfolio companies. This is due to the fact that all available resources in portfolio companies are generally used for the purposes of growing the business and increasing the value of the companies. Interview with Santavirta 2019.

portfolio companies[145].[146] The laws applicable on the calculation of the taxable income depend on the source of income[147]. In legal praxis, income derived from private equity activities is treated as business income[148]. Therefore, when a business partnership solely conducts private equity activities, taxable income received by the partnership is calculated in accordance with the BITA[149]. Since private equity funds are usually established for a special purpose of carrying on private equity activities, the basic assumption of this thesis is that Finnish private equity funds solely conduct private equity activities.

The calculation of taxable income of Finnish private equity funds treated as business partnerships is largely based on the funds' annual accounts[150]. The profit and loss account of the financial statements serves as a basis for the computation of the taxable income[151]. The accounting profit showed in the profit and loss account is, however, adjusted by certain items that are treated differently for bookkeeping purposes compared to tax purposes[152]. Firstly, taxable income items[153] that are not included in the accounting profits are added to the amount of taxable profits. Secondly, tax exempt income items counted in the accounting profits are deducted from the amount. Thirdly, the amount is adjusted by non-tax-deductible costs that are treated as deductible costs in bookkeeping. Lastly, tax-deductible costs that are

[145] The basic assumption of this thesis is that portfolio companies are non-listed limited liability companies. This assumption is based on the fact that limited liability companies are the most commonly used form for carrying on business in Finland. See, e.g., Mähönen – Villa 2015, p. 1.
[146] See, e.g., Vilppula 2005, p. 171.
[147] In Finland, income may be treated as business income (*elinkeinotoiminnan tulo* in Finnish), agricultural income (*maatilatalouden tulo* in Finnish), or other income (*henkilökohtainen tulo* in Finnish). Income derived from business activities, agricultural activities, and personal activities are all calculated separately, and tax losses are always deducted from the same income source in which they have been accrued, by virtue of Section 16 of the ITA. Business income is taxed according to the BITA, whereas the taxation of agricultural income follows the special rules of the FITA. Personal income is, in turn, taxed in accordance with the general rules of the ITA. As of January 2020, all types of income generated from commercial activities by resident companies will be treated as business income and taxed under the BITA. Since business partnerships are not considered to be residents for Finnish tax purposes, the amendment will not affect them and thus is not further discussed herein. For more information on the amendment, see Government Proposal 257/2018 vp.
[148] See KVL 227/1993; KVL 190/1994; KVL 118/1995; KVL 121/1998; SAC 1998:30; SAC 2001:11; SAC 2002:34; SAC 2005:74; KVL 7/2008; KVL 35/2008, confirmed by SAC 2009 T 1619; SAC 2010:12; and SAC 2013:29. See also Government Proposal 306/2018 vp. In judicial literature, see Vilppula 2005, p. 169; Heiniö 2006, p. 269; Vilppula 2007, pp. 5–6; Juusela 2007, p. 96; and Andersson – Penttilä 2016, p. 34, footnote 33.
[149] The question on the income classification may, however, still be relevant with regard to Finnish private equity funds engaged in real estate investment activities. See SAC 2007:10. See also Penttilä 2010, p. 253, footnote 5; and Andersson – Penttilä 2016, p. 34, footnote 33.
[150] Myrsky – Malmgrén 2014, p. 64. Finnish private equity funds formed as limited partnerships are liable to keep annual accounts that contain, inter alia, the financial statements comprising a profit and loss account, balance sheet, and notes to the financial statements by virtue of Section 1 of Chapter 3 of the Accounting Act.
[151] Myrsky – Malmgrén 2014, p. 64.
[152] The rules under which possible adjustments are made to the accounting profits depend on the applicable tax law rules. See more in Myrsky – Malmgrén 2014, p. 64.
[153] The starting point is that all business income received in the form of cash or a benefit having a monetary value is subject to tax in Finland, on the basis of Section 4 of the BITA.

not treated as deductible costs in bookkeeping are deducted from the amount of taxable profits.[154]

When analysing the taxation of capital payments, one should note that such payments are not exhaustively defined in the Finnish tax legislation[155]. Pursuant to Section 6(1)(2) of the BITA, items in the form of share capital or subscribed capital, or other capital investments received by a corporation, are not taxable income. Based on the wording of the provision, such income items received by a limited partnership are not tax exempt. In legal and taxation praxis, the provision has been deemed to also cover capital payments received by limited partnerships[156]. Hence, capital payments in Finnish private equity funds are not subject to income taxation in Finland.

The income received by Finnish private equity funds mainly consists of proceeds from the disposals of shares in portfolio companies. Shares in portfolio companies owned by Finnish private equity funds are treated as the funds' fixed assets (*käyttöomaisuus* in Finnish) by virtue of Section 12 of the BITA[157]. Hence, consideration received from disposals of shares in portfolio companies is subject to tax under Section 5(1)(1) of the BITA. Such income is allocated to the tax year during which a binding contract on the share disposal is concluded[158]. It is essential to note that Section 6(1) of the BITA under which proceeds from share disposals could, under certain circumstances, be exempt from tax is never applicable to Finnish private equity funds[159].

Since Finnish private equity funds may also receive interest and dividends, the taxation of these income items is also addressed. In general, both of these income items are subject to

[154] See Myrsky – Malmgrén 2014, p. 65. See more about the relationship between taxation and accounting in Torkkel 2011, pp. 81–273 and Engblom *et al.* 2018, pp. 87–157.
[155] See Järvenoja 2013, p. 405.
[156] See Myrsky – Linnakangas 2010, pp 133–134; Järvenoja 2013, pp. 405–406; Tikka *et al.* 2014, p. 184; and Andersson – Penttilä 2016, p. 163.
[157] See KVL 26/2004, confirmed by SAC 2005 T 3776; and SAC 2005:74. Cf. Heiniö 2006, p. 271; Niskakangas 2004, p. 253; and Penttilä 2010, pp. 253–254. In judicial literature, it is not held perfectly clear whether such shares should be treated as fixed or current assets (*vaihto-omaisuus* in Finnish) of Finnish private equity funds. Without going further into details, one should note that even though the classification of the shares is not relevant when assessing whether or not income from the share disposals is taxable income, as it is in both cases, the classification of the shares may have an impact on the tax treatment of possible write-offs of the shares.
[158] Despite the clear ground rule, it might be difficult to determine when a binding contract has been concluded. For instance, the use of different kinds of signing-closing mechanisms in transactions might create uncertainty if it is not unambiguous whether or not a binding contract has been concluded at the time of the signing. In this event, special attention should be paid to the nature of the contract at the time of the signing by determining whether the contract is a letter of intent or rather a binding contract with a termination clause. See Tikka *et al.* 2014, p. 200. See more in Klemettilä 2012, pp. 546–554.
[159] See, e.g., Viitala 2007, p. 5; Juusela 2007, p. 96; Penttilä 2010, p. 254; and Wikström 2014, p. 445.

tax in Finland[160]. Therefore, interest and dividends are fully included in the taxable income of the funds. However, when the income is allocated to the partners, the part of dividend income that would be tax exempt, if the partner received it from a direct investment is deducted from the partner's income share[161]. The deduction is made before the calculation of the amount of income share separately for each partner in accordance with applicable Finnish domestic tax law, EU law, and tax treaty provisions.

2.4.3 Tax-deductible Costs

In addition to the profit distributions, the cash outflow of Finnish private equity funds mainly comprises management fees and other expenses related to share acquisitions and advisory services. All expenses incurred in obtaining or preserving income subject to taxation are deductible by virtue of Sections 7, 8, 17, and 18 of the BITA. Since costs related to the acquisition of shares in portfolio companies have incurred in obtaining income subject to taxation, such costs are deductible[162]. If the fund disposes shares in a portfolio company at loss, meaning that the share acquisition costs exceed the proceeds from the disposal of the shares, there is no taxable income. Capital losses incurred on disposals of shares in portfolio companies are counted as ordinary business losses and are deducted from the corresponding future profits during the subsequent ten fiscal years[163].

Since private equity funds use advisory services in connection with share acquisitions, the funds incur expenses associated with such services. The advisory costs may be treated either as annual expenses under Section 22 of the BITA or as part of the shares' acquisition costs. If they are treated as annual expenses, the costs will be deducted upon arising. In turn, their treatment as acquisition costs means that they will be deducted from the eventual proceeds from the disposals of shares to which the advisory costs are related. According to the FTA, advisory costs that are closely connected to share acquisitions are capitalised into acquisition costs, unless proved otherwise[164]. The approach taken by the FTA is based on the legal praxis[165]. Hence, the tax treatment of advisory costs is ultimately based on the evaluation

[160] Section 5(1)(3) of the BITA.
[161] Pursuant to Section 16(3) of the ITA, dividend income may be tax exempt on the basis of Section 6a of the BITA.
[162] Section 8(1)(2) of the BITA.
[163] Section 7 of the BITA. See Government Proposal 92/2004 vp, pp. 64–65.
[164] Guidance of the FTA A67/200/2018, Chapter 2.1.
[165] See KVL 64/2010, confirmed by SAC 2011 T 1205; and SAC 2004:93.

whether the services are deemed to be more closely connected to share acquisitions or the ordinary course of business of the fund[166].

As observed, Finnish private equity funds pay management fees for the management services of the fund. There are no special provisions governing the tax treatment of management fees in the BITA. Since the ratio of management fees is to compensate the general partner for the management services provided for the fund, the fees should be treated as expenses of the fund, and thus deductible costs[167]. In addition to management fees, funds make capital repayments and profit distribution payments to the partners during the realisation phase. Since capital payments received by Finnish private equity funds are not subject to tax in Finland by virtue of Section 6(1)(2) of the BITA, capital repayments and profit distribution payments cannot be deducted from the taxable income computed at the fund level[168].

The classification of carried interest is also relevant when determining which expenses are tax-deductible[169]. The tax treatment of carried interest depends on the fact whether it is treated as an item of profit-distributive nature or a tax-deductible cost similar to management fees[170]. If carried interest is treated as a tax-deductible cost, it can be deducted in the calculation of taxable income at the fund level. Otherwise, carried interest is not deductible in taxation.[171] As a conclusion, the determination of the tax treatment of carried interest is of great relevance in connection with both the calculation and allocation of taxable income.

With regard to other possible expenses, Finnish private equity funds may bear interest expenses related to obtaining loan financing from, for instance, the partners or financial institutions. Interest expenses of the funds are generally tax-deductible costs on the basis of

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166 For a more detailed analysis on the tax treatment of expenses related to advisory services, see Guidance of the FTA A67/200/2018, Chapter 2.1.
167 This interpretation is supported by the preparatory works of the ITA. In an example presented in the preparatory works, a management fee is treated as a tax-deductible cost in the taxation of a foreign investor in a Finnish private equity fund. See more in Government Proposal 64/2005 vp, pp. 7–8. See also Vilppula 2005, p. 173. Without going into specifics, one could be argued that a management fee received by a general partner should not be tax-deductible if it substantially exceeds the actual costs incurred from the management of the fund. In this event, the management fee could rather be regarded as an item of profit distribution.
168 See Tikka *et al.* 2014, p. 213.
169 The classification of carried interest has been under scrutiny in judicial literature. See, e.g., Viitala 2005, pp. 171–174; Järvenoja 2013, pp. 351–353; Sääski Keskitalo 2015; and Ohtonen – Peni 2017.
170 Even though the scope of this thesis is narrowed to address the tax treatment of foreign investors in Finnish private equity funds, one should note that the classification of carried interest is relevant for the general partner as it determines whether the carried interest is taxed as earned income or capital income. See Sääski Keskitalo 2015, pp. 64–67.
171 For a more detailed analysis on the tax treatment of carried interest in Finland, see Ohtonen – Peni 2017.

Sections 7 and 18(1)(2) of the BITA[172]. However, the deductibility of interest expenses has been limited by Section 18a of the BITA from the tax year 2014 onwards. At first, the interest deduction limitation concerned only related party undertakings[173], but as of the tax year 2019, the limitation has been extended to also cover third party undertakings, such as loans from financial institutions[174]. Unless Finnish private equity funds are exempted from the interest limitation rule on the basis of the Finnish equity ratio exemption[175], they may deduct interest expenses on their loans only to the extent allowed by Section 18a of the BITA.

2.5 Tax Treatment of Losses

The last topic concerns the tax treatment of losses in Finland. If the net business income of a Finnish private equity fund is negative, the incurred losses may be carried forward and set off against future business income during the subsequent ten fiscal years under Section 119 of the ITA[176]. Since business losses are confirmed to a Finnish private equity fund treated as a business partnership and deducted against its business income by virtue of Section 16 of the ITA, the partners are not able to deduct the fund's business losses in their own taxation[177]. This means that tax losses are deducted solely from the fund's future taxable profits, and

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[172] See, e.g., SAC 2014:119. See also Penttilä 2010, p. 253.

[173] The current interest limitation rule allows net interest expenses to be deducted up to a maximum of 25% of taxable EBITD. However, the limitation does not apply if interest expenses do not exceed the total amount of interest income. With regard to the exceeding part of interest expenses, interest expenses related to related party undertakings are deductible if the total amount of net interest expenses, including interest expenses to third party undertakings, does not exceed 500 thousand euro in a tax year. If the expenses exceed this threshold, the limitation is applied to the full amount of the interest expenses and not just to the amount exceeding the threshold. Parties are treated as related when one party has direct or indirect control over the other party or a third party has control over both parties in a manner referred to in Section 31(2) of the Act on Assessment Procedure, pursuant Section 18a(6) of the BITA.

[174] However, interest expenses on third party loans taken before 17 June 2017 are excluded from the scope of application of the new interest limitation rule, by virtue of Section 18a(4)(2), provided that the terms and conditions of the loan have remained unchanged from 17 June 2016 onwards. What distinguishes third party undertakings from related party undertakings is that interest expenses on third party loans are always deductible up to three million euro as long as they are at arm's length and related to the company's business. See more in Government Proposal 150/2018 vp, pp. 48–49, 85.

[175] Without going further into details, the application of the Finnish equity ratio exemption in private equity fund structures has turned out to be problematic in legal praxis. See KVL 42/2017, confirmed by SAC 2018 T 65. See Vesikansa – Stellato 2018 for a comprehensive and detailed analysis on the theme.

[176] Carry-back of losses is not possible in Finland, which means that a loss-making Finnish private equity fund is not able to deduct its losses unless it generates taxable income in the future. The suggestion of adopting Finnish tax law rules enabling carry-back of losses is regularly discussed in connection with evaluating the tax incentives for growth companies in Finland. See, e.g., TEM 29/2009, p. 12; and Press release of the FiBAN 2019. However, *Mikkola* is sceptical towards the likelihood of adoption of rules on carry back of losses in Finland as the change would be of fundamental nature. Interview with Mikkola 2019.

[177] The SAC has confirmed that partners are not able to deduct losses of a business partnership in their own taxation. The SAC held that the debts of the partnership were not deductible expenses of the partners upon dissolution of the business partnership. See more in SAC 1993 B 522.

thus cannot be transferred to the partner level for tax deduction purposes[178]. Tax losses cannot be transferred to the partners even in a situation where the fund is liquidated[179].

Even though the main rule is that losses may be carried forward and set off against future taxable income during the subsequent ten fiscal years, the right to carry forward of tax losses might be forfeited. Pursuant to Section 122(1) of the ITA, the right to carry forward of tax losses will be forfeited if more than 50% of the shares in a business partnership are transferred during or after the year in which the losses were incurred. Furthermore, if a corresponding change in ownership happens in a corporate entity or business partnership that owns at least 20% of the shares in a Finnish company with unused tax losses, the shares in the former are deemed to be transferred. Hence, the risk to forfeit losses is not limited to Finnish private equity funds as also the portfolio companies of whose shares the funds own at least 20% may forfeit their unused tax losses due to the change in ownership at the upper level.

When determining the application of Section 122(1) of the ITA to Finnish private equity funds formed as limited partnerships, it is not relevant if 50% of the partners have changed, because the decisive factor is whether or not more than 50% of the shares in the partnership have been transferred. The ownership structure may change, for instance, when a partner disposes their share in or a new partner enters into the partnership.[180] Section 122(1) of the ITA and its preparatory works do not expressly define the term '*shares in the partnership*'. The lack of definition is problematic in terms of limited partnerships due to the fact that limited partners usually make their contributions in the form of capital whereas general partner(s)'s contributions may be a combination of capital and labour input, or solely labour input[181]. As a consequence, the limited partners' shares are not directly comparable to those of general partners[182]. Since there is no statutory rule on the comparability of the partners' shares, the provision leaves a plenty of room for interpretation[183].

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178 See Järvenoja 2013, p. 602; and Villa – Ossa 2017, p. 171.
179 See SAC 1993 B 522. In judicial literature, *Andersson* and *Penttilä* have considered that a conversion of a limited partnership into an unregistered firm in accordance with Section 24(1)(4) of the ITA should not be deemed as a change in ownership in the meaning of Section 122 of the ITA. See Andersson – Penttilä 2016, p. 76, footnote 15.
180 Guidance of the FTA A223/200/2016, Chapter 1.2.
181 See Järvenoja 2013, p. 604.
182 See Nuotio 2012, p. 175; and Järvenoja 2013, p. 604.
183 The FTA also admits in its detailed guidance on the interpretation of Section 122(1) of the ITA in connection with limited partnerships that it is not clear on the basis of the wording of the provision whether a transfer of a limited partner's share is equal to a transfer of a general partner's share or not. See Guidance of the FTA A238/200/2017.

According to the FTA, the change in ownership in limited partnerships is determined on a case-by-case basis in case of a transfer of limited partners' shares. In making that assessment, the FTA takes into account, inter alia, contractual provisions governing partners' responsibilities and obligations. In addition, the FTA pays attention to the total amount of contributions made by each limited partner as such and in relation to the contributions made by general partners.[184] Based on the FTA's instructions on the interpretation of Section 122(1) of the ITA in terms of limited partnerships, the assessment is based on analysing the relative proportion of transferred shares in relation to other shares instead of merely focusing on the monetary amount of committed capital[185].

In the light of the foregoing, an admission or exit of a limited partner should only have relevance when 50% of the general partners' shares have changed hands. In this case, the decisive factor is whether or not more than 50% of the limited partners' shares have been transferred.[186] However, the FTA states that an admission or exit of a limited partner may also cause a change in ownership in the meaning of Section 122(1) of the ITA. This could be the case if the relation between the limited partner and general partner as agreed in the partnership agreement or other agreement significantly differs from the provisions of the Partnership Act[187].

The FTA specifies that a significant decision making power of limited partners or remarkably greater contribution made by limited partners compared to the one made by the general partner may be taken into account when determining whether or not a change in ownership in the meaning of Section 122 of the ITA has taken place when only limited partners' shares have been transferred[188]. In other words, a limited partnership may forfeit its unused tax losses even if no shares of the general partners have changed hands. This special situation has been evaluated by the Administrative Court of Helsinki in its recent legal praxis.

> In 2018, the Administrative Court of Helsinki held that a Finnish private equity fund formed as a limited partnership forfeited its unused tax losses when its general partner redeemed the

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[184] See Guidance of the FTA A238/200/2017.
[185] See Guidance of the FTA A238/200/2017. The standpoint of the FTA is based on legal praxis of the SAC. See SAC 1991 B 543; and SAC 1996 T 3551. For a thorough analysis on the decisions of the SAC, see Nuotio 2012, pp. 176–180.
[186] See SAC 1991 B 543. The FTA has confirmed this standpoint to be the starting point in the interpretation of Section 122 of the ITA in Guidance of the FTA A238/200/2017. In judicial literature, *Nuotio* has drawn the same conclusion on the basis of the above-mentioned legal praxis. See Nuotio 2012, p. 179.
[187] See Guidance of the FTA A238/200/2017.
[188] *Ibid*.

limited partners' shares in the partnership. The Court emphasised the fact that the limited partners' contributions were approximately ten times greater than the value of the general partner's share.[189]

The ruling of the Administrative Court of Helsinki does not, however, have the force of law and is currently pending before the SAC. Thus, it is too early to draw any meaningful conclusions about the ruling[190]. In the view of the author, the current legal position is not sufficiently precise and clear in a way that limited partnerships and their partners could be fully aware of the consequences of changes in the ownership structure. As a conclusion, Finnish private equity funds that have confirmed unused tax losses or own portfolio companies with such losses should carefully evaluate possible consequences of exits of both their general partner(s) and limited partners as well as potential admissions of new partners[191].

The objective of Section 122(1) of the ITA is to prevent new partners from benefiting from tax losses incurred before they entered into the partnership[192]. Hence, the provision restricts potential tax planning and prevents shares with confirmed unused tax losses from becoming objects of trade[193]. It is worth noting that the FTA may grant a dispensation to allow the utilisation of forfeited tax losses if it is deemed to be necessary for the continuation of the company's activities[194]. If the dispensation is granted, losses can be deducted from future taxable income with the same time limit as if the ownership change had not taken place. However, if there is no future taxable income from which the losses could be deducted, it is possible that the losses cannot be utilised at all in Finland[195].

[189] See Administrative Court of Helsinki, 16.2.2018, No. 18/0154/6.
[190] When handling the case, the SAC has to decide how much weight it gives to the previous court decisions from the 1990s. The circumstances have obviously changed a lot during the past three decades. With regard to Finnish private equity industry, it is not unprecedented that general partners do not contribute any capital into Finnish private equity funds formed as limited partnerships. Thus, the ball is now in the SAC's court and its task is to carefully evaluate the direction in which the application of Section 122(1) of the ITA should be taken.
[191] In the light of the foregoing considerations, Section 122(1) of the ITA may also cause practical problems in private equity structures as the risk of forfeiting unused tax losses may prevent investors acting as limited partners from receiving the general partner's consent for the transfer of shares in case one or several investors wish to exit from the fund.
[192] Matikkala 1990, p. 222, footnote 284; and Järvenoja 2013, p. 602.
[193] Järvenoja 2013, p. 602.
[194] Section 122(3) of the ITA. See more about the dispensation in the Guidance of the FTA A223/200/2016, Chapters 3, 4, and 5.
[195] In other words, neither the partnership nor partners may utilise the losses from previous fiscal years. A partial relief for this situation is that the partners may, under certain circumstances, deduct these losses via a dissolution of the partnership. See more in Immonen – Ossa – Villa 2012, pp. 88, 196–197.

2.6 Conclusions

To sum up, Finnish private equity funds are generally formed as limited partnership. Since there are not special laws governing Finnish private equity funds, they operate within the framework of the Partnership Act and general contractual rules. The application of the Partnership Act is almost entirely discretionary as partners of limited partnerships may agree to deviate from a great number of the default rules of the law. Consequently, partners of Finnish private equity funds may flexibly agree on, inter alia, governance, fundraising, and profit distribution of the funds.

Even though Finnish private equity funds formed as limited partnerships are treated as legal persons with their own rights and obligations, they are not considered to be separate tax subjects in Finland. In other words, Finnish private equity funds are treated as fiscally transparent entities for Finnish tax purposes. Despite the fiscal transparency, the funds are not, however, completely disregarded for Finnish tax purposes as they function as accounting units to whom the total amount of business income is computed. Although the computation of taxable income is carried out at the fund level, income is always taxed solely in the hands of the partners.

3 TAXATION OF FOREIGN INVESTORS IN FINNISH PRIVATE EQUITY FUNDS

3.1 Introduction

The efficiency of global economy requires that cross-border economic activities are neither disfavoured nor favoured in taxation in comparison with purely domestic economic activities[196]. Accordingly, tax neutrality is widely regarded as one of the basic principles of a good taxing system in market economies[197]. Simply put, taxation is considered to be neutral when it directly affects only the levying of taxes without distorting the decisions that individuals and companies would otherwise make for purely economic reasons[198]. Therefore, taxation should not affect the functioning of the markets[199]. In the context of private equity fund investments, taxation should affect as little as possible the investment decisions taken by private equity investors.

Since the purpose of the basic freedoms is to ensure the proper functioning of the internal market, the abolishment of tax obstacles standing in the way of a well-functioning internal market is a high priority for the EU[200]. Such tax obstacles[201] may impel foreign investors to stay on their national markets in order to avoid, for instance, international double taxation or excessive administrative burdens, and thus improperly affect the investors' decisions as to where to trade, incorporate, and invest[202]. The purpose of Chapter 3 is to explore the

[196] See Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Basic Principles of International Tax Law, Tax Neutrality.
[197] See more about the principles of a good tax system in, e.g., Aalto 1988, pp. 8–9; Tikka 1990, pp. 47–49; Kukkonen 1994, pp. 351–356; Juusela 1998, pp. 48–52; and Wikström 2008, pp. 139–161.
[198] For more information on tax neutrality in the context of cross-border investments, see Vapaavuori 1991, pp. 50–53; and Juusela 1998, pp. 52–63.
[199] See Helminen 2019, Chapter 3, Fundamentals of International Tax Law, Basic Principles of International Tax Law, Tax Neutrality.
[200] Despite the fact that the Finnish tax laws do not contain any statutory provisions prohibiting non-neutrality in taxation, Article 18 of the TFEU and Article 24 of Finland's tax treaties prohibit non-discrimination on the basis of nationality. The tax treatment of foreign investors may also conflict with the special articles of the TFEU granting the basic freedoms. See, e.g., C-81/87 Daily Mail; C-118/96 Safir; and C-251/98 Baars. If the tax treatment simultaneously violates the general non-discrimination rule expressed in Article 18 of the TFEU and one or several basic freedoms, the special article granting the basic freedom must be applied instead of Article 18 of the TFEU. Due to the fact that the special articles cover almost the entire scope of application of the TFEU, Article 18 of the TFEU is seldom applied. See, e.g., C-305/87 Commission v Greece; C-1/93 Halliburton; C-311/97 Royal Bank of Scotland; C-251/98 Baars; joined cases C-397/98 and C-410/98 Metallgesellschaft and Others; C-422/01 Skandia and Ramstedt; C-443/06 Hollmann; and C-240/10 Schulz-Delzers. See also Helminen 2018, p. 66; and Terra – Wattel 2019, pp. 49–50.
[201] Tax obstacles may arise in connection with, for example, taxes on cross-border goods and services, differences in the tax treatment of domestic and imported goods and services, differences in the tax treatment of resident and non-resident taxpayers, and, obviously, international double taxation. See Helminen 2018, p. 28; and Terra – Wattel 2019, pp. 3–4.
[202] See for a similar example in Terra – Wattel 2019, p. 4.

Finnish international tax environment into which foreign investors enter at the time when they invest in Finnish private equity funds.

3.2 Tax Liability and Residency of Foreign Investors

3.2.1 Tax Liability in Finland

When determining the tax treatment of investors in Finnish private equity funds, it is essential to examine whether or not they are subject to tax in Finland. The tax liability of all investors is determined solely on the basis of the ITA[203]. Section 9(1)(1) of the ITA sets forth that a Finnish resident individual, corporation, joint venture, and estate of a deceased person are liable to tax in Finland on their global income (also referred to as *persons subject to unlimited tax liability*). Accordingly, persons subject to unlimited tax liability are taxed following the residence state principle, as both national residents and non-national residents of Finland are liable to tax on all of their income regardless of its source[204].

With regard to non-resident persons, Section 9(1)(2) of the ITA stipulates that a non-resident individual and foreign corporate entity are liable to tax in Finland only on their Finnish sourced income (also referred to as *persons subject to limited tax liability*). All investors in Finnish private equity funds who are deemed to be persons subject to limited tax liability are referred to as foreign investors in this study. Since foreign investors are liable to tax in Finland only on their Finnish sourced income, Finland applies the source state principle in their taxation[205]. As an observation, merely the nationality has no impact on the determination of investors' tax liability status in Finland[206].

The determination of the tax liability status is important for all investors as persons subject to unlimited tax liability and persons subject to limited tax liability are governed by a different set of rules. Where the taxation of persons subject to unlimited tax liability is primarily based on the ITA and assessed in accordance with the Act on Assessment

[203] See SAC 1978 B II 515; and SAC 1979 B II 508. See also Nykänen 2015, p. 88. Even though the tax liability status of investors is solely determined on the basis of the ITA, tax treaties and EU law may restrict Finland's right to levy tax on income received by the investors. See, e.g., Government Proposal 306/2018 vp, p. 4.
[204] See Nykänen 2015, p. 85.
[205] See Andersson – Linnakangas – Frände 2016, p. 66. See Nykänen 2015, pp. 84–87; and Helminen 2019, Chapter 4, International Double Taxation and Double Non-Taxation, Territorial Extent of Taxing Powers, Domestic Tax Law of Finland for more information on the application of different taxing principles in Finland.
[206] Despite the fact that Finland does not apply the nationality principle in taxation, the application of the residence state principle may be considered to be supplemented by the nationality principle in respect of Finnish citizens who are deemed to be subject to limited tax liability in Finland for a certain period of time after they have emigrated from Finland. See Nykänen 2015, p. 86.

Procedure, the taxation of persons subject to limited tax liability is governed by the Act on Taxation of Non-residents. One of the major differences between these approaches relates to the obligation to file a tax return as persons subject to limited tax liability do not have to file one in Finland provided that taxes on income items received by them have been withheld at source.[207]

3.2.2 Classification as Foreign Corporate Entities

First of all, one should be aware of the fact that partners in Finnish private equity funds may be corporate entities, individuals, or partnerships. Partners who are treated neither as persons subject to limited tax liability nor as persons subject to unlimited tax liability are not separate tax subjects for Finnish tax purposes. As observed in Chapter 2, Finnish private equity funds established as limited partnerships are not separate tax subjects in Finland. Due to the fact that from incorporated investors only the legal entities treated as foreign corporate entities are subject to limited tax liability in Finland, this section outlines when foreign investors in Finnish private equity funds are deemed foreign corporate entities within the meaning of Section 9(1)(2) of the ITA[208].

Based on the wording of the provision, a legal entity must meet two conditions in order to be subject to limited tax liability in Finland. Firstly, the entity has to be deemed to be foreign for Finnish tax purposes and, secondly, it must be classified as a corporate entity under Finnish tax laws. When addressing the question on the origin of a legal entity, one should note that Finnish tax laws do not include any provisions defining when a corporate entity is considered as foreign or Finnish[209]. In general, a corporate entity is regarded to be Finnish only when it is registered or otherwise established under Finland's domestic laws[210]. Analogously applied, a corporate entity is foreign if it is incorporated abroad or otherwise

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[207] Since this thesis focuses on the tax treatment of investors subject to limited tax liability, issues related to the taxation of investors subject to unlimited tax liability are not further discussed herein. The tax treatment of persons subject to limited tax liability is discussed in greater detail in the course of this Chapter 3.

[208] As observed in Chapter 2, the investor base of private equity funds in Finland generally consists of institutional investors, such as pension insurers, banks, and insurance companies, as well as other large-scale investors, such as different kinds of funds, public operators, and large or medium-large companies and their holding companies. Even though there may also be individuals as investors, the tax treatment of foreign individuals in Finland is excluded from the scope of research of this thesis.

[209] Nykänen 2015, p. 107; Andersson – Linnakangas – Frände 2016, p. 71; Malmgrén – Myrsky 2017, pp. 314–315; and Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax residence, Unlimited and Limited Tax Liability, Companies and Estates of a Deceased Person.

[210] Government Proposal 306/2018 vp, p. 13. See also Sainio 1976, pp. 63–64; Malmgrén 2008, p. 284; Nykänen 2015, p. 107; Andersson – Linnakangas – Frände 2016, p. 71; Malmgrén – Myrsky 2017, p. 314; and Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax residence, Unlimited and Limited Tax Liability, Companies and Estates of a Deceased Person.

established under the laws of a foreign state[211]. Therefore, a corporate entity cannot be deemed to be Finnish for Finnish tax purposes solely on the basis of having its place of management in Finland[212].

With regard to the classification of foreign legal entities as corporate entities in Finland, one should note that Finnish tax legislation contains neither an explicit definition of the term '*foreign corporate entities*' nor any special provisions for the classification of foreign legal entities. Consequently, the domestic tax law provisions governing the classification of Finnish legal entities are applied.[213] The classification of Finnish legal entities is based on Sections 3, 4, and 5 of the ITA under which legal entities are divided into corporate entities, partnerships, and joint ventures.

Legal entities regarded as corporate entities are specified in Section 3 of the ITA. First and foremost, limited liability companies, co-operative societies, savings banks, investment funds, special investment funds, and mutual insurance companies are treated as corporate entities for Finnish tax purposes. Moreover, Section 3 of the ITA sets forth that universities, loan granaries, ideological and economic associations, foundations and institutions as well as foreign estates of deceased persons are considered as corporate entities. Furthermore, the tax treatment of corporate entities applies to the state and its institutions as well as the municipalities, joint municipal authorities, and religious communities.[214]

The classification of foreign legal entities as corporate entities for Finnish tax purposes derives its legal basis from Section 3(7) of the ITA. The provision stipulates that also special purpose bodies of property or any other legal persons that are comparable to the above-listed entities are treated as corporate entities for Finnish tax purposes. Without going further into details, foreign legal entities are classified by determining whether the whole of the characteristics of the entities resembles more the one of Finnish corporate entities rather than the one of Finnish partnerships or joint ventures[215].

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[211] Malmgrén – Myrsky 2017, p. 63; and Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax residence, Unlimited and Limited Tax Liability, Companies and Estates of a Deceased Person, Corporate Entities.
[212] See SAC 1971 T 5016; and SAC 1990 T 4325. See also Nykänen 2015, p. 108.
[213] Lammi 2015, p. 518.
[214] Previously, Section 3 of the ITA included Paragraph 5 under which partnerships and joint ventures were also treated as corporate entities. However, the taxation of partnerships was amended to a large extent in 1990's as they become fiscally transparent for Finnish tax purposes following the example of numerous other states. See more about the legislative change in Government Proposal 256/1994 vp, p. 2.
[215] See Nykänen 2015, p. 121; and Helminen 2019, Chapter 6, Forms of Doing Business and Business Profits, Corporate Entities, Entities Treated as Corporate Entities. For a thorough and comprehensive analysis on the classification of foreign legal entities in Finland, see Lammi 2015.

In legal praxis, the SAC has held that, for instance, a Cayman Islands *Ltd*[216], Belgian *Naamloze Vennootschap*[217], Swiss *Aktiengesellschaft*[218], and Luxembourg *Fonds Communs de Placement*[219] are treated as corporate entities for Finnish tax purposes. As an interesting remark, the last-mentioned legal entity form is considered to be a fiscally transparent entity under Luxembourg law, but it was treated as a separately taxable person for Finnish tax purposes[220]. Thus, simply the fact that a foreign legal entity is treated as a fiscally transparent entity in the state where it is established does not automatically lead to the same classification in Finland and *vice versa*[221]. Moreover, it is worth noting that companies having the same legal form may be classified differently in Finland if they deviate from each other in a way that they are comparable to different Finnish legal entities[222].

The wording of Section 3(7) of the ITA on which the classification of foreign legal entities is based leaves room for interpretation. This is due to the fact that it is not perfectly clear whether the requirement on comparability with one of the corporate entities mentioned in other paragraphs of Section 3 of the ITA concerns both special purpose bodies of property and legal persons or only the latter. The common interpretation of the provision among legal scholars is that the requirement on comparability is also applied to special purpose bodies of property[223]. However, both of these viewpoints on the interpretation of Section 3 (7) of the ITA have been represented in legal praxis of the SAC.

> The SAC held in its ruling, SAC 2015:59, that an investment management company registered as an US *Delaware Statutory Trust* was considered to be comparable to a Finnish

[216] SAC 1999:25.
[217] SAC 2002:26.
[218] SAC 2003:49.
[219] SAC 2004:116. Luxembourg companies formed as *Fonds Communs de Placement* have been treated as investment funds in the KVL's decisions KVL 8/2013 and KVL 14/2013. See more about the classification of these legal entities in Finland in Koskeniemi 2014, pp. 428–438.
[220] See the SAC's reasoning in SAC 2004:116. See also Koskenniemi 2014, pp. 430, 435–436, footnote 51.
[221] See, e.g., Nykänen 2015, p. 106; and Helminen 2019, Chapter 6, Forms of Doing Business and Business Profits, Corporate Entities, Entities Treated as Corporate Entities.
[222] These kinds of significant differences within the same group of legal entities might result, for instance, from the discretionary nature of the law under which they are established. See more in Lammi 2015, pp. 522, 528.
[223] In judicial literature, *Helminen*, *Karhu*, *Malmgrén* and *Äimä* have considered that the comparability requirement also applies to special purpose bodies of property. See Malmgrén 2008, p. 276; Äimä 2009, p. 405; Karhu 2012, p. 402; and Helminen 2019, Chapter 6, Forms of Doing Business and Business Profits, Corporate Entities, Entities Treated as Corporate Entities. On the basis of examples on special purpose bodies of property presented by *Andersson*, *Linnakangas* and *Frände*, it could be deemed that they do not require comparability from special purpose bodies of property. See Andersson – Linnakangas – Frände 2016, pp. 40–41. *Lammi* has, however, pointed out that even though the comparability requirement has not been brought up in connection with the examples, which were also presented in the previous edition, the examples could actually be tacitly compared to, for instance, associations and foundations on which their treatment as separate corporate entities would be based. See Lammi 2015, p. 520.

public company limited by shares instead of a Finnish investment fund. Even though the SAC concluded that the investment management company is comparable to a limited liability company, the SAC stated in its reasoning that if the company was regarded to be comparable to a special purpose body of property referred to in Section 3(7) of the ITA, its dividend income would be taxable. Hence, based on the wording of the reasoning, it could be considered that a foreign legal entity could be classified as a special purpose body of property solely by virtue of Section 3(7) of the ITA.[224]

As a comparison, the SAC referred to Section 3(7) of the ITA together with Section 3(4) of the ITA when determining the comparability of the Luxembourg *Fonds Communs de Placement* in its ruling, SAC 2004:116[225]. This approach suggests that the comparability with one of the entities mentioned in other paragraphs of Section 3 of the ITA is indeed required from both legal persons and special purpose bodies of property. All in all, it can be concluded that the recent legal praxis of the SAC has created legal uncertainty with regard to the classification of foreign legal entities for Finnish tax purposes[226].

In addition to domestic tax law provisions, foreign legal entities must be classified in accordance with EU law[227]. From the EU law perspective, it is especially important to determine if a foreign legal entity is comparable to a Finnish limited liability company, investment fund, or special investment fund. This is due to the fact that Finnish sourced dividend income received by such entities is generally exempt from corporate taxation in the EU Member States[228]. Domestic tax rules leading to an incorrect classification of foreign legal entities could be deemed to be discriminative on the basis of EU law if similar Finnish legal entities may benefit from a more favourable tax treatment in Finland.

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[224] For a more detailed analysis on this case, see Lammi 2015, pp. 251–252.

[225] *Ibid*.

[226] In cases of doubt, a taxpayer may apply for an advance ruling on their income taxation from the Central Tax Board and tax offices on the basis of Sections 84 and 85 of the Act on Assessment Procedure. Advance rulings issued by these instances are binding on the tax authorities, but not on the taxpayers. For more information on advance rulings, see, e.g., Puronen 2010, pp. 60–72; and Tikka *et al.* 2019, Chapter 35, Ennakkoratkaisu.

[227] The founding treaties together with Article 49 of the TFEU on the freedom of establishment and Article 63 of the TFEU on the free movement of capital and payments, which is also applicable in relation to third states, are generally regarded to be the most relevant provisions that have to be taken into account when classifying foreign legal entities in the EU Member States. See Koskenniemi 2014, p. 428; and Lammi 2015, p. 518. For more information on the impact of the basic freedoms on relations with third states, see Fontana – Tenore 2007; and Smit 2011.

[228] The tax exemption of dividend income received by limited liability companies is based on Section 6a of the BITA under which dividends between domestic corporate entities are exempt from tax. In turn, Finnish investment funds and special investment funds are exempt from tax in accordance with Section 20a of the ITA. See more in Malmgrén – Myrsky 2017, p. 317.

3.2.3 *Tax Treaty Residence*

The tax treatment of foreign investors residing in a state with whom Finland has concluded a tax treaty may significantly differ from the tax treatment of other foreign investors. The extent to which tax treaties may limit Finland's right to levy tax on income received by foreign investors in Finnish private equity funds depends on the investors' tax treaty residence. This is due to the fact that the tax treaty residence of foreign investors determines whether one of the contracting states and which one of them is the investors' state of residence for tax treaty purposes. However, one should note that the investors' tax treaty residence does not affect their tax liability status in Finland as tax treaties may only limit, but not otherwise modify Finland's taxing rights.[229]

In general, tax treaties only apply to a person who is a resident of one or both of the contracting states[230]. Therefore, foreign investors have to be considered as persons within the meaning of the tax treaty concerned and as residents at least in one of the contracting states. Most of Finland's tax treaties stipulate that the term '*person*' includes an individual, a company[231], and any other body of persons[232]. The definition of the term is not exhaustively defined and is meant to be used in a very wide sense, including, for instance, foundations and partnerships[233]. Hence, the decisive factor is whether or not the investors are treated as residents in one or both of the contracting states.

All Finland's tax treaties define the term '*resident*' in the same manner as the OECD Model by containing a reference to the domestic law definition of the contracting states. Article 4 of the OECD Model sets forth that 'the term "*resident of a Contracting State*" means any person who, under laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature'. The term also

[229] See Malmgrén – Myrsky 2017, p. 86; and Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax residence, Tax Treaty Residence, Relevance of Residence.
[230] Article 1 of the OECD Model. See more in Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax residence.
[231] Pursuant to Article 3(1)(b) of the OECD Model, a company 'means any body corporate or any entity that is treated as a body corporate for tax purposes'.
[232] See Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax Residence, Tax Treaty Residence, Relevance of Residence, Tax Treaty Subjects.
[233] See paragraph 2 of the Commentary on Article 3 of the OECD Model 2017, p. 94. It should be noted that tax treaties may also exclude certain legal entities from the scope of application of a tax treaty despite the fact that they are resident in at least one contracting state. See, for instance, Article 29 of the tax treaty concluded between Luxembourg and Finland.

includes the state and any political subdivision or local authority.[234] However, a person who is liable to tax in a contracting state only in respect of income from sources in that state or capital situated therein is not considered to be a resident of that state.

Accordingly, the residence concept of tax treaties derives its meaning from the domicile and residence concepts of domestic tax laws of the contracting states. Therefore, a person may be considered to be a resident in Finland for tax treaty purposes only if the person is subject to unlimited tax liability under Finnish tax laws. With regard to corporate entities, this means that they have to be Finnish companies within the meaning of Section 9(1)(1) of the ITA in order to be treated as Finnish residents for tax treaty purposes[235]. In turn, corporate entities that are deemed to be foreign under the Finnish tax laws are not treated as residents of Finland for tax treaty purposes because they are liable to tax in Finland only on their Finnish sourced income. In case both Finland and another contracting state regard a corporate entity as a resident under their domestic tax laws, the place of effective management determines which one of the contracting states is the state of residence of the person for tax treaty purposes[236].

Most of Finland's tax treaties do not contain a special provision governing the tax treatment of partnerships. Even though partnerships qualify as persons under tax treaties, they are often not treated as separate tax subjects. Due to the lack of a tax treaty residence, partnerships are not generally entitled to tax treaty benefits.[237] Since Finnish partnerships are not separate tax subjects under the Finnish tax laws, Finland cannot be considered their state of residence for tax treaty purposes. Hence, Finnish partnerships may benefit from tax treaty benefits only

[234] Based on the OECD Model, a recognised pension fund is considered to be a resident of the state in which it is constituted despite the fact that the fund may benefit from a limited or complete exemption from taxation in that state. See more in paragraphs from 10.3 to 10.18 of the Commentary on Article 3 as well as paragraphs from 8.6 to 8.10 of the Commentary on Article 4 of the OECD Model 2017.

[235] As observed in Subchapter 3.2, Finnish resident individuals, corporate entities, joint ventures, and estates of a deceased person are liable to tax in Finland on their global income and capital, whereas non-resident individuals and foreign corporate entities are liable to tax in Finland only on their Finnish sourced income. In addition, European companies (SEs) that are registered under Finnish domestic laws and have their place of management in Finland have been considered to qualify as Finnish tax residents. See, e.g., KVL 35/2004.

[236] Almost all of Finland's tax treaties contain the term '*place of effective management*', but also the terms '*head or main office*' and '*day-to-day executive management*' are used. According to *Urpilainen*, it is not clear how the terms differ from each other in practice. See more in Urpilainen 2018, p. 270.

[237] See Helminen 2019, Chapter 5, Unlimited and Limited Tax liability and Tax Residence, Tax Treaty Residence, Determination of the State of Residence, Partnerships.

on the condition that the other contracting state treats them as residents of that state for tax treaty purposes.[238]

The application of tax treaties to partnerships was discussed in a report *The Application of the OECD Model Tax Convention to Partnerships* published by the OECD in 1999. Based on the report, the source state should apply the tax treaty between the original source state of income and the residence state of each partner when determining the tax treatment of income derived through a partnership, if the partnership is treated as a fiscally transparent entity. Provided that none of the partners are residents in the partnership state, the tax treaty between the original source state of income and the partnership state is applied only in order to determine whether the partnership is considered resident for tax treaty purposes and if it constitutes a permanent establishment in the partnership state.[239]

3.3 Determination of Taxable Income

3.3.1 Finnish Sourced Income

Since foreign investors treated as foreign corporate entities for Finnish tax purposes are liable to tax in Finland only on their Finnish sourced income, this Section 3.3.1 outlines when income items are deemed to originate from Finland. As observed in Chapter 2, income received by foreign investors through Finnish private equity funds generally consists mainly of capital gains received from disposals of shares in portfolio companies. In addition, foreign investors may receive dividends and interest through the funds. This part of the study focuses on analysing which income items are subject to tax in Finland when received by foreign investors in Finnish private equity funds.

An exemplary list of Finnish sourced income items is included in Section 10 of the ITA. Despite the exemplary nature of the list, the list is exhaustive in respect of income items

[238] See Matikkala 1995, p. 194; OECD 1999, pp. 13–17; Helminen 2002, p. 238; and Helminen 2019, Chapter 6, Forms of Doing Business and Business Profits, Partnerships, Tax Treatment of Partnerships, Tax Treatment under Finnish Domestic Tax Law.

[239] See more in OECD 1999. In legal praxis, see, e.g., KVL 195/1997. See also Government Proposal 306/2018 vp, p. 13. In judicial literature, see Helminen 2002, p. 238; Barenfeld 2005, pp. 139–143; and Helminen 2019, Chapter 5, Unlimited and Limited Tax liability and Tax Residence, Tax Treaty Residence, Determination of the State of Residence, Partnerships. The main conclusions of the report have been included in the OECD Model in 2014. However, one should note that the report merely discussed the application of tax treaties to partnerships, leaving other transparent entities aside. For the sake of clarity, Article 1 of the OECD Model was supplemented by adding a second paragraph under which income of transparent entities is treated, for the purposes of the OECD Model, in accordance with the above-mentioned report on partnerships. See more in OECD 2015, pp. 139–143. In judicial literature, see Kollmann – Roncarati – Staringer 2016.

explicitly mentioned therein[240]. Section 10(1)(10) of the ITA stipulates that capital gains are deemed to be from Finnish sources only when they are received from sales of immovable property in Finland[241] or disposals of shares in Finnish residential housing companies, other companies limited by shares, or co-operative societies more than 50% of whose total assets consist of immovable property situated in Finland. Since only the above-described capital gains are considered to be from Finnish sources, Finland does not levy tax on capital gains received by foreign investors from disposals of shares in other companies[242].

With regard to dividends, foreign investors are liable to tax in Finland solely on dividend income and other comparable income received from Finnish limited liability companies and other Finnish corporate entities, by virtue of Section 10(1)(6) of the ITA. Also, interests received from Finnish individuals, corporate entities, partnerships, joint ventures, and estates of deceased persons are considered to be Finnish sourced income under Section 10(1)(7) of the ITA. Finnish sourced dividend and interest income may, however, be tax exempt on the basis of special domestic tax law provisions and tax treaties in spite of the fact that they are expressly mentioned in Section 10 of the ITA. For instance, Finnish sourced interest income received by a non-resident person is often tax exempt on the basis of Section 9(2) of the ITA and Section 3(8) of the Act on Taxation of Non-residents[243].

3.3.2 Effects of Tax Treaties

As a conclusion of the preceding section, foreign investors engaged in private equity activities are generally liable to tax in Finland only on capital gains received from sales of

[240] See International Taxation Handbook of the FTA 2015, p. 23; Nykänen 2015, pp. 125–126; Malmgrén – Myrsky 2017, p. 252; and Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax residence, Tax Treatment of Persons Subject to Limited Tax Liability.
[241] One should note that Section 10(1)(10) of the ITA is only applied to capital gains received from immovable property when the company owns it directly. See SAC 2013:101. See also Nykänen 2015, p. 380.
[242] In other words, capital gains received from disposals of shares in portfolio companies are not subject to tax in Finland even if the assets of the portfolio companies consist of immovable property provided that the value of such property is in total less than 50% of the companies' gross assets. For a more detailed analysis of the tax treatment of capital gains received from share disposals, see Helminen – Knuutinen 2013, pp. 615–670. See also Ossa 2013, pp. 31–32; and Andersson – Linnakangas – Frände 2016, pp. 101–102. In this context, it should be noted that income derived from immovable property located in Finland and income from letting premises held by virtue of shares in Finnish residential housing companies, other companies limited by shares, or co-operative societies are considered to be from Finnish sources on the basis of Section 10(1)(1) of the ITA. Therefore, such income received by foreign investors is subject to tax in Finland.
[243] Section 9(2) of the ITA stipulates that persons subject to limited tax liability are not liable to tax on interest income derived from Finnish bonds, debentures, and other mass instruments of debt, or from loans from abroad that are not considered as capital investment assimilated to the debtor's own capital, as well as interest from deposits in banks or other financial institutions and from foreign trade credit accounts. As a result of the broad tax exemption granted by Section 9(2) of the ITA, Finland seldom levies tax on interest income received by foreign investors. See Nykänen 2015, p. 179; Malmgren – Myrsky 2017, pp. 391; and Helminen 2019, Chapter 9, return on Equity and Debt, Interest, Interest of a Non-resident, No Permanent Establishment in Finland.

immovable property and disposal of shares in Finnish residential housing companies, other companies limited by shares, or co-operative societies more than 50% of whose total assets consist of immovable property situated in Finland. In addition, dividends derived from Finnish companies are generally subject to tax in Finland. As to Finnish sourced interest income received by foreign investors, special tax provisions broadly exempt such interest income from tax in Finland.

With respect to foreign investors' capital gains received from sales of immovable property in tax treaty situations, one should note that Finland's tax treaties allow Finland to levy tax on all capital gains from the alienation of immovable property situated in Finland[244]. Therefore, also foreign investors residing in Finland's tax treaty states are liable to tax in Finland on capital gains received from sales of immovable property that is located in Finland. Moreover, it is important to note that also all income from such immovable property, including income derived from the direct use, letting, or use in any other form of such immovable property[245], is taxable income in Finland[246].

In turn, Finland's right to levy tax on other capital gains by virtue of Section 10(1)(10) of the ITA depends on the fact whether or not the tax treaty concerned includes a provision allowing Finland to tax capital gains also from disposals of shares in Finnish real estate companies that entitle the use of the companies' immovable property even though the shares themselves do not constitute immovable property[247]. One should note that even if such provision is included in the tax treaty concerned, the provision may require that a greater amount than 50% of the total assets consist of immovable property[248]. Furthermore, if Finland wishes to tax, for instance, rental income received from such property, the tax treaty concerned should also include a separate special provision allowing the taxation of such income[249].

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[244] Article 13(1) of the OECD Model. See Nykänen 2015, p. 279; and Helminen 2019, Chapter 11, Movable and Immovable Property, Tax treatment of Income from Immovable Property, Non-resident Taxpayer, Capital Gains, Tax Treaties.

[245] Article 6(3) of the OECD Model.

[246] Articles 6(1) and 6(4) of the OECD Model.

[247] See Nykänen 2015, p. 380–381; and Helminen 2019, Chapter 11, Movable and Immovable Property, Tax Treatment of Income from Immovable Property, Non-resident Taxpayer, Capital Gains, Tax Treaties.

[248] For instance, Article 13(2) of the Nordic Tax Treaty sets forth that Finland's taxation right requires that at least 75% of the total assets consist of immovable property located in Finland. See Nykänen 2015, p. 380; and Helminen 2019, Chapter 11, Movable and Immovable Property, Tax Treatment of Income from Immovable Property, Non-resident Taxpayer, Capital Gains, Tax Treaties.

[249] See Nykänen 2015, pp. 375–376; Räbinä – Myllymäki 2016, p. 391; and Helminen 2019, Chapter 11, Movable and Immovable Property, Tax Treatment of Income from Immovable Property, Non-resident Taxpayer, Current Income, Tax Treaties.

In addition to the domestic special provisions, tax treaties may also restrict Finland's right to levy tax on dividend and interest income received by foreign investors. With regard to dividend income, Finland's tax treaties generally require the application of a reduced withholding tax rate. The maximum withholding tax rate typically varies between 0% and 15% depending on the tax treaty concerned[250]. As for interest income, Finland has generally given up its right to tax interest income received by foreign investors residing in a tax treaty state[251]. To sum up the effects of tax treaties, foreign investors residing in a tax treaty state are generally more lightly taxed in Finland compared to other foreign investors.

3.3.3 Permanent Establishment

Despite the foregoing considerations, foreign investors may be subject to tax in Finland on their global income if they are deemed to have a permanent establishment in Finland. Pursuant to Section 9(3) of the ITA, non-resident individuals as well as foreign corporate entities and partnerships having a permanent establishment in Finland for conducting business are liable to tax on all income attributable to that permanent establishment. In the context of foreign investors in Finnish private equity funds, this means that all income, including all capital gains[252] as well as tax exempt dividends and interest[253], received through Finnish private equity funds is subject to tax in Finland if the investors have a permanent establishment in Finland to which such income is deemed to be attributable.

The concept '*permanent establishment*' is defined both in the ITA and Finland's tax treaties[254]. The definition found in Finland's tax treaties is based on Article 5 of the OECD Model. Pursuant to Article 5(1) of the OECD Model, 'a permanent establishment means a

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[250] See Nykänen 2015, p. 386; and Helminen 2019, Chapter 9, Return on Equity and Debt, Dividends, Finnish-source Dividends of Non-residents, Effect of Tax Treaties.
[251] See Helminen 2019, Chapter 9, Return on Equity and Debt, Interest, Interest of a Non-resident, No-Permanent Establishment in Finland, Effect of Tax Treaties.
[252] In this context, one should note that in tax treaty situations capital gains received from immovable property located abroad are not taxable income in Finland even though the gains would be regarded to be connected with a permanent establishment in Finland. See Article 6, 13(2), and 21 of the OECD Model as well as paragraph 4 of the Commentary on Article 21 of the OECD Model 2017. See also Helminen 2019, Chapter 11, Movable and Immovable Property, Tax Treatment of Income from Immovable Property, Non-resident Taxpayer, Capital Gains, Tax Treaties.
[253] Also interest income that would be tax exempt by virtue of Section 9(2) of the ITA becomes subject to income tax if it is deemed to be attributable to a permanent establishment in Finland. See, e.g., Malmgrén – Myrsky 2017, p. 391.
[254] It should be noted that the permanent establishment concept is also relevant for VAT purposes. Based on legal praxis, the definition of a permanent establishment that applies for VAT purposes does not affect the corresponding definition in income taxation. For this reason, the VAT based definition of a permanent establishment is not analysed in this thesis. See, e.g., KVL 187/1994. See also International Taxation Handbook of the FTA 2013, p. 267.

fixed place of business through which the business of an enterprise is wholly or partly carried on.' The domestic tax law definition is included in Section 13a of the ITA. The provision defines a permanent establishment as a place with a specific place of business for the purposes of permanent conducting of business or as a place where special arrangements have been made.

The starting point of tax treaties is that profits of a foreign company may be subject to tax only in the company's state of residence, unless the company carries on business in the other contracting state through a permanent establishment situated therein[255]. This means that if there is an applicable tax treaty, Finland is allowed to levy tax on income received by foreign investors from business conducted in Finland only if such income is connected with their permanent establishment located in Finland[256]. Therefore, the tax treaty definition of a permanent establishment is of more significant relevance in tax treaty situations as foreign investors may have a permanent establishment in Finland only by virtue of the tax treaty concerned[257].

Even though the domestic tax law definition and tax treaty definition of a permanent establishment are slightly differently worded, the settled interpretations of the OECD Model are also relevant when interpreting the definition of the ITA[258]. First of all, there has to be a '*place of business*', which may be any premises, facilities or installations used for conducting business[259]. In order to be held as a permanent establishment the place of business has to be fixed in terms of its geographical location and duration, meaning that it cannot be of purely temporary nature[260]. The fixed place of business may constitute a permanent establishment for a company only if the company's business is at least partly effectuated

[255] Article 7 of the OECD Model.
[256] See, e.g., SAC 1977 T 4748; and SAC 1990 T 3921.
[257] A non-exhaustive list of examples of a permanent establishment is stipulated in Article 5(2) of the OECD Model and Section 13a of the ITA. See more about the examples of a place of business in Helminen 2019, Chapter 6, Forms of Doing Business and Business Profits, The Concept of Permanent Establishment, Examples of a Place of Business.
[258] For more information on the interpretation, see Government Proposal 76/1995 vp and Commentary on Article 5 of the OECD Model 2017. See also Sainio 1976, pp. 121–167; Skaar 1991; Suurnäkki 1994; Helminen 2004a, pp. 35–42; Helminen 2004b, pp. 20–29; Malmgrén 2008, pp. 218–242, 301–369; Malmgrén – Sivonen 2009, pp. 283–295; Sasseville – Skaar 2009, pp. 17–63; and Helminen 2019, Chapter 6, Forms of Doing Business and Business profits, Permanent Establishment.
[259] It is essential to note that a place of business may also exist even if there are no premises available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. See paragraph 6 and 10 of the Commentary on Article 5 of the OECD Model 2017, pp. 117–118.
[260] See paragraph 6 of the Commentary on Article 5 of the OECD Model 2017, p. 117; and paragraph 28 of the Commentary on Article 5 of the OECD Model 2017, p. 122.

through this place[261]. This means that persons who are dependent on the company, *id est* personnel, conduct the business in the state where the fixed place is located[262]. However, a company may also be deemed to have a permanent establishment in Finland by virtue of a representative or agent even if there is no place of business at its disposal[263]

Prior to the year 2002, it was unclear whether or not Finnish private equity funds constitute a permanent establishment in Finland for their foreign investors[264]. The general starting point is that a limited partnership may create a permanent establishment for its non-resident partners only if the partnership and its partners carry on business activities in the partnership state[265]. Hence, solely being a limited partner in a Finnish limited partnership should not create a permanent establishment for a non-resident limited partner[266]. The legal uncertainty regarding the tax treatment of foreign investors in Finnish private equity funds was solved in 2002 when the SAC dealt with the question in its ruling SAC 2002:34.

> A corporate entity carrying on private equity investment activities is regarded to carry on business activities. The business of a limited partnership should be the basis for determining the source of income accruing to a partner of the partnership. If a limited partnership carries on business activities via a permanent establishment located in Finland, any portion of its income should be treated as similar income in the hands of its partners. Taking into account Articles 3(2) and 7(1) of the Nordic Tax Treaty, the SAC held that it could not be considered that Finland had given up its right to tax A AB for the income received through B Ky. The ruling was a result of a vote (3 votes in favour, 2 votes against[267]).

To sum up, the SAC considered that the business of the partnership should be the basis for determining the source of income accruing to the limited partners of the partnership. As the

[261] See paragraph 6 of the Commentary on Article 5 of the OECD Model 2017, p. 117. Business operations must be carried out on a regular basis, but there may be interruptions of operations. See paragraph 35 of the Commentary on Article 5 of the OECD Model 2017, p. 124

[262] See paragraph 6 of the Commentary on Article 5 of the OECD Model 2017, p. 117.

[263] A dependent agent may constitute a permanent establishment, if such a person has been given the authority to act on behalf of the company and, in doing so, the person 'habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise'. Such contracts must be either 'in the name of the enterprise', or 'for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use', or 'for the provision of services by that enterprise'. See Article 5(5) of the OECD Model.

[264] See Lehtimaja 2006, p. 43. *Viitala*, in turn, has considered that the ruling merely endorsed the general assumption under which foreign investors acting as limited partners of Finnish partnerships are deemed to have a permanent establishment in Finland. See more in Viitala 2005, p. 515.

[265] See Daniels 1991, p. 90; and Helminen 2002, p. 239.

[266] See Helminen 2002, p. 239; and Lehtimaja 2002, p. 448.

[267] A minority of the members in the SAC regarded that the Nordic Tax Treaty prevented Finland from taxing income of A AB received as a limited partner of B Ky.

limited partnership had carried on business through a permanent establishment in Finland, income derived from the partnership had the same character, *id est* income from a permanent establishment, when distributed to the limited partners. In practice, this meant that an investment in a Finnish private equity fund created a permanent establishment in Finland for its foreign investors acting as limited partners when the partnership had a permanent establishment in Finland[268]. Hence, the ruling allowed Finland to levy tax on income received by foreign investors through the Finnish private equity fund as the fund was deemed to carry on private equity activities through a permanent establishment located in Finland[269].

The ruling has been broadly criticised due to its ambiguous reasoning[270]. Some critics have noted that the SAC did not, in fact, state explicitly that the limited partner's participation in the partnership as such constituted a permanent establishment in Finland[271]. Instead, the SAC merely concluded that the applicable Nordic Tax Treaty did not limit Finland's right to tax income received by the partner from the Finnish limited partnership. In judicial literature, *Lehtimaja* has criticised especially the fact that both the KVL and the SAC concluded that B Ky conducts business from a permanent establishment in Finland without any reasoning for this conclusion[272]. In any case, the ruling provided an answer to the question whether or not income received through Finnish private equity funds is treated as income from a permanent establishment for their foreign investors.

In addition to the ambiguous reasoning, the ruling has been criticised due to the fact that it placed investments made through Finnish private equity funds in a less attractive position compared to direct investments in Finland. This resulted from the fact that foreign investors are generally not liable to tax on capital gains derived from share disposals, unless they have a permanent establishment in Finland. However, as a result of the ruling, foreign investors in Finnish private equity funds became liable to tax on all income received from the funds,

[268] In judicial literature, *Vilppula* has pointed out that other activities of foreign investors may also create a permanent establishment for them in Finland, and investments in Finnish private equity funds may be deemed to be connected to this permanent establishment. See Vilppula 2005, p. 177.
[269] Foreign investors in Swedish and Norwegian private equity funds have also been regarded to have a permanent establishment in those states. See Government Proposal 64/2005 vp, p. 2.
[270] See Lehtimaja 2002, pp. 447–452; Westerlund – Aalto 2003, pp. 589–590; Viitala 2005, p. 515; and Vilppula 2005, pp. 176–179.
[271] See Lehtimaja 2002, p. 450; and Viitala 2005, p. 515.
[272] Lehtimaja 2002, p. 450.

including capital gains[273]. Consequently, it became more efficient for foreign investors to either invest directly in Finnish companies or use foreign private equity funds as investment vehicles instead of Finnish limited partnerships[274].

3.4 Special Tax Regime

The unattractive tax treatment of foreign investors in Finnish private equity funds was also noted by Invest Europe[275] in its benchmark paper published in 2003. The paper revealed that Finland provided one of the least favourable tax and legal environments for private equity funds in the EU[276]. In the same year, the Finnish Government announced that it will prepare a legislative amendment to Finnish tax laws for the purpose of equalising the tax treatment of foreign capital in Finnish private equity funds and portfolio companies[277]. The tax treatment of foreign private equity investors was amended by adding the following Subsection 5 to Section 9 of the ITA:

> Notwithstanding Subsection 3, provided that Finland and the state of residence of a limited partner subject to limited tax liability in a limited partnership engaged solely in private equity activities have concluded a tax treaty, the part of income received by the limited partnership corresponding the share of the partner is taxable only to the extent that the income would have been subject to tax when received directly by the partner. If the partner's taxable income exceeds the partner's share in the partnership's income, the exceeding part thereof is taxable income during the ten subsequent fiscal years as income share accrues. A limited partnership engaged in private equity activities means a limited partnership whose sole purpose *de facto* is to conduct private equity activities according to its partnership agreement.[278]

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[273] For instance, if a tax exempt investment institution had invested through a Finnish private equity fund, it would have been subject to extra tax cost of 29%, which was the corporate income tax rate back in 2002. Hence, the ruling placed investments made through a Finnish private equity fund in a less attractive position compared to direct investments and foreign private equity funds. The tax treatment of private equity limited partnerships was not neutral as it distorted the decisions that individuals and companies would otherwise make for purely economic reasons. See Juusela 2007, p. 98.
[274] Government Proposal 64/2005 vp, p. 2. See also, e.g., Passinen 2007, p. 141.
[275] Invest Europe, formerly known as the EVCA, is an association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.
[276] The Finnish tax and legal environment was deemed to be unfavourable especially due to the fact that Finland was one of the few states where the participation of foreign investors in Finnish private equity funds created a permanent establishment for the investors. See more in EVCA 2003, pp. 7, 12.
[277] Government Proposal 64/2005 vp, p. 3. The proposal was in line with the programme of the Finnish government. See Programme of Prime Minister Vanhanen's Government 2003, p. 37. The Finnish government considered that the tax neutrality between direct investments and indirect investments requires that capital gains received through a Finnish private equity fund would not be taxable income for limited partners subject to limited tax liability. Moreover, the amendment was regarded to improve the competitiveness of Finnish private equity funds and their management companies. See Government Proposal 64/2005 vp, p. 7.
[278] Translated by the author.

Simply put, the application of Section 9(5) of the ITA means that limited partners subject to limited tax liability in Finland are taxed for their share in the income of Finnish private equity funds only to the extent that the income would be taxable in Finland if the partners received it directly from the funds' portfolio companies. Accordingly, all income items that would be tax exempt for limited partners when received directly from portfolio companies are also tax exempt when received through Finnish private equity funds when the special provision is applied.[279] Since interest and capital gains received by foreign investors are generally not taxable income in Finland, foreign investors benefitting from the special tax regime are liable to tax in Finland only on their Finnish sourced dividend income[280].

The special tax regime granted by Section 9(5) of the ITA was, however, deemed to be inapplicable to foreign investors investing in Finnish private equity funds through funds of funds. The non-applicability of Section 9(5) of the ITA in fund of funds structures is based on legal praxis, as follows.

> In case KVL 67/2011, a Norwegian limited liability company, A AS, had invested in a Finnish limited partnership carrying on private equity activities through a Danish limited partnership, B K/S. Based on the wording of Section 9(5) of the ITA, the special provision may only be applied to a share in income of a Finnish limited partnership engaged in private equity activities received by a non-resident limited partner in the partnership. Due to the fact that A AS was not a limited partner in E Ky, the KVL ruled that Section 9(5) of the ITA could not be applied to the part of E Ky's income corresponding the share of A AS.

To sum up, the KVL held that Section 9(5) of the ITA requires foreign investors to be direct limited partners in Finnish private equity funds in order to enjoy the special tax treatment. Since this was not the case in respect of A AS investing in E Ky through B K/S, A AS was not deemed to be a limited partner in E Ky in the meaning of Section 9(5) of the ITA. Accordingly, foreign investors investing in Finnish private equity funds through foreign funds of funds were subject to tax in Finland on all income derived through the Finnish private equity funds as they were not able to benefit from the special tax treatment.

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[279] See Viitala 2005, pp. 514–517; Svennas – Makkonen 2005, pp. 103–108; Lehtimaja 2006, pp. 43–50; and Helminen 2019, Chapter 6, Forms of Doing Business and Business Profits, Partnerships, Tax Treatment of Partnerships, Limited Partners Engaged in Capital Investment.

[280] See Government Proposal 64/2005 vp, p. 6. See also Juusela 2007, p. 99. As noted in Subchapter 3.3, capital gains received from disposal of shares in Finnish residential housing companies or any other companies more than 50% of whose total assets consist of immovable property situated in Finland are considered Finnish sourced income. Hence, capital gains received by foreign investors through Finnish private equity funds engaged in real estate activities may be subject to tax in Finland.

The SAC confirmed the conclusion of the KVL in 2013. The SAC also held that the wording of Section 9(5) of the ITA prevented the application of the special tax treatment to foreign investors using a fund of funds as an investment vehicle because the special provision only concerned limited partners of limited partnerships[281]. In 2019, the SAC followed the same approach when it confirmed the KVL's decision, KVL 34/2018[282]. In this case, a foreign investor investing in a Finnish private equity fund through another Finnish limited partnership was held to be unable to benefit from the special tax treatment under Section 9(5) of the ITA[283]. As a result of the above-described legal praxis, foreign investors using funds of funds in their private equity activities were indirectly restricted from investing in Finnish private equity funds[284].

In May 2018, the Finnish Ministry of Finance published a working group report on the assessment of the tax treatment of different investment forms, including private equity funds formed as limited partnerships, in terms of functioning, neutrality, and the extent to which the tax treatment is up to date and provides the right incentives[285]. It was considered in the report that the objective of the special provision had not been achieved in respect of fund of funds structures[286]. As a conclusion, the working group stated that there are grounds for extending the application of the special tax regime to also cover foreign investors investing in Finnish private equity funds through a fund of funds[287].

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[281] KVL 67/2011, confirmed by SAC 2013 T 283.

[282] It is essential to note that the SAC confirmed the decision of the KVL only in respect of the tax year 2018. This is due to the fact that the special tax treatment may be applied to foreign investors investing in Finnish private equity funds through funds of funds as of the beginning of the tax year 2019. However, the SAC did not take a stand on the issues of fact and law when it referred the case back to the KVL. See SAC 2019 T 1934. In the light of the information obtained, there should be no impediment for the application of the special tax treatment in the case provided that the Finnish private equity fund concerned also meet all conditions imposed on it as Section 9(5) of the ITA was already deemed to be applicable at the upper level.

[283] KVL 34/2018, confirmed by SAC 2019 T 1934.

[284] According to *Santavirta*, funds of funds are mainly used by very large investors not willing to look for the best investment opportunities by themselves. Instead, they invest in funds of funds that look for the best target companies and smaller private equity funds on their behalf. There may also be smaller investors investing through funds of funds with the purpose of testing, for instance, the Nordic markets by investing in several private equity funds located in the area. After finding out the profits received from the investments, the investors decide into which market they enter. Interview with Santavirta 2019. Since these investors were not able to enjoy the special tax treatment in Finland, they were indirectly restrained from investing in Finnish private equity funds.

[285] See more in Ministry of Finance publications 14/2018.

[286] Ministry of Finance publications 14/2018, pp. 172–173. The working group emphasised the growing significance of the question by referring to the recently launched VentureEU programme. Since the idea of the programme is to support funds of funds investing in private equity funds in the EU Member States, the question on funds of funds was considered to be of greater relevance.

[287] The working group, however, noted that the amendment requires further analysis regarding technicalities. See more in Ministry of Finance publications 14/2018, pp. 173–180.

Following the working group report and active lobbing by the FVCA[288], an amendment to Section 9 of the ITA was presented to the Finnish Parliament in December 2018. The application of the special tax regime was proposed to be extended to also cover fund of funds structures by adding Subsection 6 to Section 9 of the ITA. The aim of the new special provision was to place foreign investors' investments through funds of funds in Finnish private equity funds investing in Finnish portfolio companies in the same position with direct investments in such companies[289]. In addition, the amendment aimed at improving the competitiveness of the Finnish private equity industry and removing obstacles from receiving foreign capital[290].

The Finnish Parliament approved the law amending Section 9 of the ITA, and subsequently Section 9(6) of the ITA entered into force on 20 March 2019. On the basis of the preparatory works, the new special provision is retrospectively applied in the tax assessment of the whole tax year 2019[291]. Section 9(6) of the ITA was added to supplement Section 9(5) of the ITA in terms of fund of funds structures:

> What is provided in Subsection 5 is also applied to a person subject to limited tax liability when the part of the income referred to in the subsection corresponding to the person's share composes of income shares from one or several Finnish or foreign partnerships, provided that Finland and the state of residence of the person subject to limited tax liability have concluded a tax treaty and that the foreign partnership is registered in or established under the laws of such a jurisdiction with whom Finland has agreed on the exchange of information in tax matters between authorities.[292]

For the sake of clarity, Section 9(6) of the ITA did not factually amend the scope of application of Section 9(5) of the ITA. Instead, the new special provision enabled the application of the special tax treatment provided in Section 9(5) of the ITA also to foreign investors investing through funds of funds. In addition to the introduction of the new special provision, Section 9(5) of the ITA was slightly amended by adding a new condition requiring a limited partnership carrying out private equity activities to be considered as an alternative investment fund under the AIFM Act. Section 9(5) of the ITA was not amended in other

[288] Interview with Santavirta 2019.
[289] Government Proposal 306/2018 vp, p. 12.
[290] The proposal was in line with the employment and competitiveness objectives of the programme of the Finnish government. See Programme of Prime Minister Sipilä's Government 2015, pp. 14–15.
[291] Government Proposal 36/2018 vp, p. 23.
[292] Translated by the author.

respects. Hence, apart from the new condition, the original special provision still applies in the same way as previously.[293]

3.5 Tax Assessment

3.5.1 Withholding Taxation

As discussed in Subchapter 3.3, foreign investors are generally liable to tax only on income items listed in Section 10 of the ITA. If all conditions laid down in Section 9(5), and Section 9(6) of the ITA in respect of fund of funds structures, are met, foreign investors may benefit from the special tax treatment. In this case, their share in income of Finnish private equity funds is taxable only for the part that would be taxable if it was received directly by the investors. Since foreign investors benefitting from the special tax regime are generally not liable to tax on capital gains and interest income, merely Finnish sourced dividend income is subject to tax in Finland when received by such investors.

Pursuant to Section 3g of the Act on Taxation of Non-residents, Finnish private equity funds formed as limited partnerships are obliged to withhold tax on all income items subject to withholding taxation included in their foreign investors' share in the partnerships' income[294]. One should note that Finnish private equity funds referred to in Section 9(5) of the ITA are required to withhold tax also in fund of funds structures[295]. Withholding tax is levied on gross income, meaning that natural deductions are not available for foreign investors. In practice, this means that foreign investors cannot deduct any expenses accrued from the acquisition of the income[296].

[293] Chapter 4 is devoted to a further analysis on different aspects related to the application of the special provisions.
[294] The obligation to withhold tax was imposed on Finnish private equity funds in connection with the enactment of Section 9(5) of the ITA. The underlying reason behind the provision is that a domestic limited partnership is usually regarded to be the receiver of dividends paid by Finnish companies. Moreover, the payer of dividends is seldom aware of whether or not a limited partnership has non-resident limited partners in whose hands the income would be subject to withholding taxation. Based on the legislative works of the provision, tax is practically withheld from profit share payments and withdrawals from a private account. See Government Proposal 64/2005 vp, pp. 6, 8.
[295] Government Proposal 306/2018 vp, pp. 17–18.
[296] However, foreign pension insurance institutions have been entitled to deduct the amount they transfer to the insurance-liability reserves of their balance sheet under certain circumstances as of 31 January 2015, on the basis of Section 3(7) of the Act on the Taxation of Non-residents and Section 8(1)(10) of the BITA. The deduction right was at first only allowed to domestic companies, but the Act on the Taxation of Non-residents was amended to also cover foreign comparable companies in order to be compliant with EU Law. The amendment followed the ECJ ruling in which dividends paid to foreign pension funds were regarded to be taxed in a discriminatory manner in Finland. See more in C-342/10 Commission v Finland. See also the preparatory works of the amendment in Government Proposal 157/2014 vp.

Only income items explicitly referred to in Section 3 of the Act on Taxation of Non-residents may be subject to withholding taxation in Finland. Taking into account the fact that taxable income of foreign investors received through Finnish private equity funds mainly consists of Finnish sourced dividends, one should note that such dividends are subject to withholding taxation by virtue of Section 3 of the Act on Taxation of Non-residents. The withholding tax rate for dividend income is determined in accordance with the Act on Taxation of Non-residents, unless dividends fall into the scope of application of the exceptions of the Act on Taxation of Non-residents[297] or a tax treaty requires a reduced withholding tax rate to be applied[298]. On the basis of Section 7(1)(2) of the Act on Taxation of Non-residents, dividends received by foreign investors treated as corporate entities for Finnish tax purposes are generally subject to withholding tax at the rate of 20%[299].

Under certain circumstances, tax on Finnish sourced dividends received by foreign investors is not withheld in Finland. For instance, Finnish sourced dividends received by certain foreign corporate entities are exempt from withholding tax if the entities are similar to Finnish corporate entities covered by Section 33d(4) of the ITA or Section 6a of the BITA[300]. Moreover, companies covered by the Parent-Subsidiary Directive may benefit from the tax rate of 0% when they directly own at least 10% of the capital of the company distributing the dividends[301]. In the light of the recent legal praxis of the ECJ, claiming the exemption from withholding tax under the Parent-Subsidiary Directive has, however, become uncertain in private equity fund structures[302].

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[297] Sections 3(5), 3(6), and 13 of the Act on Taxation of Non-residents.

[298] Section 1(3) of the Act on the Taxation of Non-residents. See more in Guidance of the FTA VH/3059/00.01.00/2018.

[299] Foreign investors that are legal entities similar to Finnish pension funds may, under certain circumstances, be entitled to a reduced withholding tax rate of 15% under Section 3(3) of the Act on Taxation of Non-residents. With respect to foreign individuals, tax on dividends is generally withheld at 30%, pursuant to Section 7(1)(4) of the Act on Taxation of Non-residents. From the perspective of foreign investors receiving Finnish sourced dividend income, it is essential that companies responsible for withholding tax on them are aware of the beneficiaries. This is due to the fact that if no information whether the beneficiary is a corporate entity or individual is available at the time when the payment is made, tax must be withheld at 30%. For more information on the applicable tax rates, see Guidance of the FTA VH/3059/00.01.00/2018, Chapter 2.

[300] Section 3(5) of the Act on Taxation of Non-residents.

[301] Section 3(6) of the Act on Taxation of Non-residents. For more information on the Parent-Subsidiary Directive in Finland, see Helminen 2018, pp. 151–171.

[302] In February 2019, the ECJ issued its decisions in six cases in six cases dealing with the interpretation of the Parent-Subsidiary Directive and Interest-Royalties Directive. Without going into specifics, the ECJ held that the EU Member States may decide to not grant the withholding tax exemptions under these directives, if the recipients are not the beneficial owners of the dividends and interest payments. Hence, these recent decisions brought legal uncertainty to the tax treatment of these income items received through different kinds of fund structures in the EU. See joined cases C-116/16 and C-117/16 T Danmark regarding the interpretation of the Parent-Subsidiary Directive, and joined cases C-115/16, C-118/16, C-119/16, and C-299/16 N Luxembourg 1 regarding the interpretation of the Interest and Royalties Directive.

In addition to the above-mentioned exceptions, tax treaties may require Finland to apply a reduced withholding tax rate on dividends received by foreign investors through Finnish private equity funds. This means that Finnish private equity funds have to be aware of each foreign investors' state of residence in order to be able to withhold a correct amount of tax on Finnish sourced dividends received through the funds[303]. In conclusion, determining the correct amount of withholding tax requires Finnish private equity funds, and ultimately their general partners, to annually keep track on the tax treatment of each of their investors under Finnish tax laws and applicable tax treaty in order to withhold the correct amount of tax each year[304].

3.5.2 *Regular Tax Assessment*

As said, withholding tax is levied solely on income items expressly specified in Section 3 of the Act on Taxation of Non-residents. In turn, income items not mentioned in the provision are subject to a regular tax assessment in accordance with the Act on Assessment Procedure by virtue of Section 13(1) of the Act on Taxation of Non-residents. Consequently, persons subject to limited tax liability are required to file a tax return in respect of income items not mentioned in Section 3 of the Act on Taxation of Non-residents in the same manner as persons subject to unlimited tax liability in Finland[305].

Pursuant to Section 10(1)(10) of the ITA, foreign investors are liable to tax on capital gains received from sales of immovable property in Finland and disposals of shares in companies more than 50% of whose total assets consist of immovable property situated in Finland.

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[303] For a more detailed analysis on the Finnish withholding taxation of dividend and interest income received by non-residents, see Helminen 2019, Return on Equity and Debt.

[304] In addition to keeping track on their investors, the funds should pay great attention to the correct categorisation of income items on their income tax returns as different income items, such as dividends and capital gains, are subject to different tax treatment in Finland. If these income items are incorrectly categorised on the tax return, tax on income received by foreign investors is very likely to be withheld incorrectly. In the interview, *Jokitie* stressed that challenges related to the correct withholding taxation are even more pronounced in fund of fund structures. According to *Jokitie*, problems generally arise in fund of funds structures when one fund receives income from another fund and fills in the whole amount in the column 'taxable portion of income' on its tax return. However, if the income comprised also dividend income, such income would most probably be subject to incorrect taxation in Finland. Therefore, it is crucial that Finnish private equity funds pay great attention to carefully and accurately fill in all their income in correct categories on their tax return. Only this way, it could be ensured that the taxation of income received by foreign investors through Finnish private equity funds is assessed correctly in Finland. Interview with Jokitie 2019. It is worth noting that this administrative obligation imposed on Finnish private equity funds might turn out to be quite burdensome if the funds receive income and have investors from various states.

[305] One should also note that if a taxpayer has been subject to unlimited tax liability in Finland during a tax year, they are required to file a tax return regardless of their tax liability status at the end of the tax year. See SAC 1990 T 712. See more in Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax Residence, Tax Treatment of Persons Subject to Unlimited or Limited Tax Liability, Tax Treatment of Persons Subject to Unlimited Tax Liability.

Moreover, income received from such property and income from letting premises held by virtue of shares in Finnish residential housing companies, other companies limited by shares, or co-operative societies, such as rental income, is subject to tax in Finland, by virtue of Section 10(1)(1) of the ITA. Since these income items are not included in Section 3 of the Act on Taxation of Non-residents, their taxation is assessed in accordance with the Act on Assessment Procedure[306]. Consequently, foreign investors receiving above-described income through Finnish private equity funds are liable to file a tax return in Finland with respect to these income items.

At this point, one should note that the combination of withholding taxation and regular tax assessment is applied to income received by foreign investors in Finnish private equity funds only when the special tax treatment is granted by Section 9(5) of the ITA, and Section 9(6) of the ITA in relation to fund of funds structures. Instead, if the special tax treatment is not applied, all income received through the funds is considered to be connected with a permanent establishment in Finland. Thus, all foreign investors not benefitting from the special tax treatment are liable to file a tax return in Finland as their taxation is fully assessed in accordance with the Act on Assessment Procedure[307]. The applicability of the special provisions is re-examined every year by the FTA[308].

3.5.3 Elimination of Double Taxation

When foreign investors receive income through Finnish private equity funds, they may be subject to tax not only in the source state but also in their state of residence[309]. This may lead to international double taxation, which occurs when the same income is taxed more than once. International double taxation may be either juridical double taxation[310] or economic

[306] Section 13(1) of the Act on Taxation of Non-residents. Therefore, foreign investors may deduct expenses incurred in obtaining or preserving income subject to taxation in accordance with the BITA. See, e.g., Nykänen 2015, p. 297; and Räbinä – Myllymäki 2016, p. 392.

[307] One should note that in this case also income items mentioned in Section 3 of the Act on Taxation of Non-residents become subject to regular tax assessment in Finland.

[308] Government Proposal 306/2018 vp, p. 10.

[309] Guidance of the FTA A70/200/2018, Chapter 8.

[310] The OECD Model defines international juridical double taxation as ‘the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods’. See OECD Model 2017, p. 9. Juridical double taxation typically occurs in connection with a simultaneous application of the residence state principle and the source state principle, which leads to a situation where the same income item is taxed twice in the hands of the same taxpayer in two different states.

double taxation in nature[311]. The main difference between these double taxation types is that the former refers to situations where the same income item is taxed at least twice in the hands of a same person, whereas the latter refers to situations in which the same income is taxed at least twice in the hands of different persons[312].

International juridical double taxation is usually eliminated in the state of residence of the investor[313]. The elimination of international juridical double taxation depends solely on domestic tax law provisions and tax treaties both within and outside the EU due to the fact that EU law does not contain a general provision prohibiting international double taxation in the EU[314]. The elimination of international juridical double taxation is globally carried out by utilising an exemption method, credit method, and deduction method[315].

In Finland, international double taxation is generally eliminated in accordance with the Act on Elimination of Double Taxation. Most of Finland's tax treaties refer to the credit method as the primary method for the elimination of international juridical double taxation in tax treaty situations[316]. The credit method requires that the state of residence of the investors allows a credit for the taxes that are levied in the source state according to the applicable tax treaty[317]. As a conclusion, the elimination of potential international juridical double taxation of foreign investors in Finnish private equity funds is generally carried out in accordance

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311 Economic double taxation, in turn, can be defined as 'the imposition of tax on the same income in the hands of different taxpayers'. Even though economic double taxation is often of domestic nature, it can also be international in nature. This is the case, for instance, when the same income is taxed first in Finland in the hands of a limited liability company and then again abroad upon distribution of profits in the hands of the company's owners residing in this latter state. One should note that in addition to a risk of double taxation, there may also exist a risk of triple taxation in a situation where three countries are involved and the same income item is subject to tax in all these three countries. For an example of this kind of international juridical double taxation, see Barenfeld 2005, p. 85.

312 See Barenfeld 2005, p. 85; and Helminen 2019, Chapter 4, International Double taxation and Double Non-Taxation, International Double Taxation and Its Elimination, Forms of Double Taxation.

313 Guidance of the FTA A70/200/2018, Chapter 8.

314 See Helminen 2019, Chapter 4, International Double Taxation and Double Non-Taxation, International Double Taxation and its Elimination, Elimination of International Juridical Double Taxation.

315 Helminen 2019, Chapter 4, International Double Taxation and Double Non-Taxation, International Double Taxation and its Elimination, Elimination of International Juridical Double Taxation, The Methods.

316 See Malmgrén – Myrsky 2017, p. 244; and Helminen 2019, Chapter 4, International Double Taxation and Double Non-Taxation, International Double Taxation and its Elimination, Elimination of International Juridical Double Taxation, Tax Treaties of Finland.

317 Some of Finland's tax treaties require the use of the exemption method under which either the state of residence of a taxpayer or the source state exempts a part or the whole amount of income received by the taxpayer. However, the use of exemption method is not absolute even in these tax treaties as they also refer to the credit method in respect to certain income items, such as dividends, interest, and royalties. See Helminen 2019, Chapter 4, International Double Taxation and Double Non-Taxation, International Double Taxation and its Elimination, Elimination of International Juridical Double Taxation.

with national tax rules of the investors' state of residence and to the extent required by the tax treaty concerned[318].

With respect to international economic double taxation, one should note that tax treaties usually only eliminate international juridical double taxation. Fortunately, international economic double taxation of direct dividends paid between Finnish corporate entities and corporate entities located in the EU or a tax treaty state is broadly eliminated in Finland[319]. However, portfolio dividends and dividends paid to or from a state with whom Finland has not concluded a tax treaty are often subject to international economic double taxation[320].

3.6 Conclusions

The Finnish international tax environment into which foreign investors enter at the moment they invest in Finnish private equity funds consists of rules included in Finnish tax laws, EU law, and tax treaties. As noted, foreign investors treated as foreign corporate entities for Finnish tax purposes are subject to limited tax liability in Finland. Such investors are liable to tax in Finland only on their Finnish sourced income. Most of the Finnish sourced income items are subject to withholding taxation, meaning that foreign investors are generally not liable to file a tax return in Finland. Since income received through Finnish private equity funds mainly comprises capital gains from disposals of shares in portfolio companies, the tax treatment of such income is of significant importance for foreign investors.

In Finnish tax legislation, the starting point is that capital gains accrued from share disposals are not treated as Finnish sourced income. Such income may, however, become subject to Finnish income tax if foreign investors have a permanent establishment in Finland. In 2002,

[318] In this context, one should note that Finland may also be required to allow a credit for foreign taxes paid by foreign investors in Finnish private equity funds not benefitting from the special tax regime. This is due to the fact that non-discrimination articles of tax treaties and Article 49 of the TFEU granting the freedom of establishment prevent Finland from placing permanent establishments in a less favourable position compared to Finnish companies. See more in Nykänen 2015, p. 359; and Helminen 2019, Chapter 6, Forms of Doing Business and Business Profits, Permanent Establishment, Non-discrimination. For more information on the elimination of double taxation in Finland, see Äimä 2011, pp. 305–327; Frände 2013, pp. 512–524; and Helminen 2019, Chapter 4, International Double Taxation and Double Non-Taxation, International Double Taxation and its Elimination, Elimination of International Juridical Double Taxation, Domestic Tax Law.

[319] For instance, Finland applies the exemption method to direct investment dividends falling into the scope of application of the Parent-Subsidiary Directive. The directive basically covers all direct investment dividends flowing between the most common forms of parent and subsidiary companies established in different EU Member States. See Helminen 2008, p. 354. See more in Helminen 2019, Chapter 4, International Double Taxation and Double Non-taxation, International Double Taxation and its Elimination, Elimination of International Economic Double Taxation, Dividends.

[320] Helminen 2019, Chapter 4, International Double Taxation and Double Non-taxation, International Double Taxation and its Elimination, Elimination of International Economic Double Taxation, Dividends.

the SAC held that a foreign investor was deemed to have a permanent establishment in Finland on the basis of its participation in a Finnish private equity fund. This meant that the foreign investor became liable to tax in Finland on all its income, including all capital gains, received through the fund. Since such income is assessed in accordance with the Act on Assessment Procedure, the foreign investor was liable to file a tax return in Finland. Subsequently, Finnish tax legislation indirectly restrained foreign investors from investing in Finnish private equity funds[321].

For the purposes of neutralising taxation and improving competitiveness of the Finnish private equity industry, two special provisions, Sections 9(5) and 9(6) of the ITA, were enacted. The special provisions enable foreign investors to invest both directly and indirectly in Finnish private equity funds in a tax efficient manner. When the special tax regime is applied, tax consequences are the same as they would be if foreign investors received the income directly from portfolio companies. In other words, the special tax regime enables flow-through tax treatment of income received by foreign investors directly or indirectly through Finnish private equity funds.

[321] See, e.g., Juusela 2007, p. 98.

4 APPLICATION OF SPECIAL TAX REGIME TO FOREIGN INVESTORS IN FINNISH PRIVATE EQUITY FUNDS

4.1 Introduction

Prior to the tax year 2019, foreign investors were not able to invest in Finnish private equity funds through funds of funds without a risk of double taxation. In 2019, the special tax regime enabling a flow-through tax treatment of income received by foreign investors in case of direct investments in Finnish private equity funds was extended to also cover foreign investors investing through funds of funds. First and foremost, the application of the special tax regime means that most of the capital gains received from share disposals are not subject to tax in Finland. Without the flow-through tax treatment, foreign investors would be liable to tax on all income, including all capital gains, derived through Finnish private equity funds. Hence, from the perspective of tax efficiency, the application of the special tax regime is crucial to foreign investors in Finnish private equity funds.

This part of the study is devoted to an extensive analysis on the application of the special provisions to foreign investors in Finnish private equity funds. The analysis is made from the perspective of both direct and indirect investments in Finnish private equity funds. At first, the conditions for applying the special provisions are introduced in the following Subchapter 4.2. After the brief introduction, the focus shifts to the core issues of this study: the conditions that have to be met on each level of the fund structure in order to apply the special tax regime. Moreover, a fundamental analysis on the main concerns regarding the application of the special provisions is provided at the end of each subchapter.

4.2 Conditions for Applying Special Provisions

The special tax treatment applies to income received by foreign investors in case of direct investments in Finnish private equity funds only if the prerequisites laid down in Section 9(5) of the ITA are met. Firstly, the application of the special tax treatment requires that foreign investors are limited partners subject to limited tax liability in a Finnish private equity fund. Secondly, there has to be an applicable tax treaty between Finland and the state of residence of the foreign investors. Thirdly, the special treatment may be applied only if the Finnish private equity fund is a limited partnership engaged solely in private equity activities. Moreover, the partnership agreement of the fund must stipulate that the purpose of the partnership is to conduct private equity activities, and it *de facto* conducts them as its sole purpose. Lastly, the fund must be an alternative investment fund under the AIFM Act.

In addition to direct investments in Finnish private equity funds, foreign investors may use funds of funds as investment vehicles in their fund structures. Section 9(6) of the ITA lays down separate conditions for the application of the special tax treatment in case of indirect investments made through one or several funds of funds. With respect to foreign investors, Section 9(6) of the ITA requires, in the same way as Section 9(5) of the ITA, that there has to be an applicable tax treaty between Finland and the state of residence of the investors. By way of derogation from Section 9(5) of the ITA, Section 9(6) of the ITA demands foreign investors to be merely persons subject to limited tax liability, not limited partners subject to limited tax liability.

As for funds of funds, Section 9(6) of the ITA requires each fund of funds to be treated as a partnership for Finnish tax purposes. In addition, all foreign funds of funds have to be registered in or established under laws of such a jurisdiction with whom Finland has agreed on the exchange of information in tax matters between authorities. One should note that Section 9(6) of the ITA does not impose any new requirements on Finnish private equity funds. Therefore, Finnish private equity funds are obliged to meet the exact same conditions in fund of funds structures as they are in case of direct investments covered by Section 9(5) of the ITA.

The following subchapters plunge into examining the above-mentioned conditions governing the application of the special provisions on the tax treatment of foreign investors in Finnish private equity funds. The prerequisites for the application of the special tax treatment are separately analysed from the perspective of Finnish private equity funds, foreign investors, and funds of funds. Hence, the conditions for applying the special tax regime are divided into three categories, as follows:

1) special provisions and Finnish private equity funds;

2) special provisions and foreign investors; and

3) special provisions and funds of funds.

The first category includes conditions imposed on Finnish private equity funds, whereas the second category contains criteria that foreign investors have to satisfy in order to enjoy the special tax treatment in Finland. The third and last category comprises conditions that funds of funds have to meet for the purpose of applying the special tax regime in fund of funds structures.

4.3 Special Provisions and Finnish Private Equity Funds

4.3.1 Private Equity Activities

This Subchapter 4.3 deals with the criteria that Finnish private equity funds have to fulfil in order for their foreign investors to benefit from the special tax treatment. First of all, Section 9(5) of the ITA sets forth that the special tax regime may be applied only if the Finnish private equity fund concerned is a limited partnership solely engaged in private equity activities. In addition, the partnership agreement of the limited partnership must stipulate that the purpose of the partnership is to conduct private equity activities, and the company *de facto* conducts them as its sole purpose. Hence, Finnish private equity funds willing to satisfy the condition may not be engaged in any other activities than private equity activities[322].

The limitation of the scope of application to limited partnerships solely engaged in private equity activities derives its justification from the rationale of the special tax regime. Based on the preparatory works, the special tax treatment is aimed to cover only activities that would not create a permanent establishment for persons subject to limited tax liability if they carried on the activities directly instead of using a Finnish limited partnership as an investment vehicle[323]. Furthermore, a condition with clear and strict limits helps to avoid difficulties in drawing the line with limited partnerships whose activities only partially consist of private equity activities[324].

Prior to the year 2005, Finnish tax legislation was unfamiliar with the concept of '*private equity activities*'. In other words, private equity activities were not covered by any special provisions but by general provisions applied to all business activities.[325] The term '*private equity activities*' was first included in Section 6 of the BITA in 2005 and a year later also in Section 9(5) of the ITA without, however, including a definition for it[326]. Since there is no statutory definition for private equity activities in the Finnish legislation, the interpretation

[322] This interpretation of the wording of the special provision is also confirmed in the preparatory works of Section 9(5) of the ITA. The preparatory works stipulate that limited partnership may not, in practice, carry on any other activities in addition to private equity activities. As an example, the preparatory works further specify that limited partnerships may not even sell services to third parties. See Government Proposal 64/2005 vp, p. 6. Accordingly, the condition is strict and very precise. See also Viitala 2007, p. 14.
[323] Government Proposal 64/2005 vp, p. 6.
[324] *Ibid*.
[325] Juusela 2007, p. 70.
[326] Government Proposal 306/2018 vp, p. 4.

of the term is based, primarily, on weakly binding sources, *id est* preparatory works and court decisions. The interpretation is supplemented by the Finnish judicial literature[327].

In terms of private equity activities, the preparatory works of Section 9(5) of the ITA refer to a definition given in a previously published government proposal on corporate and capital tax reform, which enacted Section 6 of the BITA[328]. Based on the government proposals, private equity activities refer to asset investments in portfolio companies that have development prospects[329]. Private equity investments in such companies are usually made in the form of equity investments[330]. However, also quasi-equity, or hybrids of debt and equity, investments are included in the definition of private equity investments[331]. With regard to the ownership, private equity investors intend to dispose their shares in portfolio companies after a pre-determined time period. Accordingly, the investors do not even intend to be permanent owners of the portfolio companies.[332]

In addition, the preparatory works state that private equity activities are characterised by the often limited time period during which new investors may join[333]. Moreover, the purpose of private equity activities is to increase the value of portfolio companies and to generate profits in the form of the increased value of the companies being sold[334]. This means that private equity investors do not usually receive any revenue before disposing of shares in portfolio

[327] There is no short and comprehensive definition for private equity activities in Finnish judicial literature. Private equity activities are generally defined to mean fairly short-term investments principally made in non-listed companies that have great development potential. Such investments are made in the expectation that the investments may be realised after a pre-determined time period. See, e.g., Lauriala 2004, pp. 21–23; Hidén – Tähtinen 2005, p. 15; Lehtimaja 2006, p. 43; and Järvenoja 2013, p. 323.

[328] Government Proposal 64/2005 vp, p. 6. Even though it has not been explicitly stated in the preparatory works, it could be considered that the concepts are identical. Therefore, legal praxis on the application of Section 6 of the BITA could also be used when interpreting private equity activities referred to in Section 9(5) of the ITA. See also Lehtimaja 2006, p. 48; and Penttilä 2010, p. 252. The definition of private equity activities is further specified in the committee report on the government proposal, VaVM 12/2004 vp, pp. 8–9. For more information on the interpretation of private equity activities in the meaning of Section 6 of the BITA, see, e.g., Juusela 2007, pp. 89–91; Penttilä 2010, pp. 252–262; Aine 2012; Siivonen 2013, pp. 545–546; and Myrsky – Malmgrén 2014, pp. 455–462. See also the FTA's guidelines on the interpretation of private equity activities in the BITA in Guidance of the FTA A32/200/2017.

[329] Government Proposal 92/2004 vp, p. 34; Government Proposal 64/2005 vp, p. 6; and Government Proposal 306/2018 vp, p. 4.

[330] Government Proposal 92/2004 vp, p. 34; Government Proposal 64/2005 vp, p. 6; and Government Proposal 306/2018 vp, pp. 4–5.

[331] For instance, convertible bonds granting the right to equity investments are covered in accordance with Government Proposal 64/2005 vp, p. 8. *Viitala* points out that many forms of mezzanine financing seem also to be covered. See more in Viitala 2005, p. 516.

[332] Government Proposal 92/2004 vp, p. 34; Government Proposal 64/2005 vp, p. 6; and Government Proposal 306/2018 vp, p. 5.

[333] Government Proposal 306/2018 vp, p. 3.

[334] Government Proposal 92/2004 vp, p. 34; Government Proposal 64/2005 vp, p. 6; and Government Proposal 306/2018 vp, p. 5.

companies, and thus their revenue primarily consists of capital gains received from the share disposals. Therefore, the main source of income from private equity activities is capital gains realised in connection with share disposals.

The concept of private equity activities has been defined more precisely in legal praxis. In 2007, the SAC evaluated the concept in the context of real estate investments and fund of funds investments[335]. The SAC concluded that both of these investment activities are considered private equity activities within the meaning of Section 9(5) of the ITA, as follows.

> In the ruling, SAC 2007:10, the SAC examined whether or not real estate investment activities could be considered private equity activities in the manner intended in Section 9(5) of the ITA. The advance ruling application stated that the partnership agreement would stipulate that the sole purpose of the Finnish limited partnership is to conduct private equity activities in the real estate industry. Investments would be made either directly or through group companies in real estates, real estate companies, or other similar targets. The fund would generate profits to its partners in the form of rental income and increased value of the targets. The SAC held that the partnership carrying on real estate investment activities is considered a limited partnership solely conducting private equity activities within the meaning of Section 9(5) of the ITA. As a result, the partnership was not obliged to withhold tax on income of the non-resident partner's share in the partnership's income other than for the part that would be taxable if the income was received directly by the partner.[336]
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> With regard to fund of funds investments, the SAC evaluated in its ruling, SAC 2007:11, whether or not such activities may be considered private equity activities within the meaning of Section 9(5) of the ITA. The purpose of a Finnish fund of funds formed as a limited partnership was to invest in private equity funds, investments companies, and other similar targets. In general, investments were made in funds located in Russia and Eastern Europe. The fund of funds was established for a limited period of time, and its profits primarily consisted of income received from divestments. The SAC took the view that the fund of funds conducted private equity activities within the meaning of Section 9(5) of the ITA. Subsequently, the fund of funds was not obliged to withhold tax on income of its non-

[335] In judicial literature, *Lehtimaja* speculated whether or not funds of funds meet the condition regarding private equity activities already in the beginning of 2006. See Lehtimaja 2006, pp. 44–45, 48. See also Viitala 2007, p. 15.

[336] See also KVL 59/2006, confirmed by SAC 2007 T 286. For a further analysis on the case, see Juusela 2007, pp. 91–92. The SAC came to the same conclusion when interpreting the term in connection with analysing the application of Section 6 of the BITA. See SAC 2013:29.

resident partner's share in the partnership's income other than for the part that would be taxable if the income was received directly by the partner.

Accordingly, Finnish private equity funds engaged in private equity activities in real estate sector or fund of funds investment activities may fulfil the condition on private equity activities imposed on them by Section 9(5) of the ITA. Hence, such investment activities are considered to be private equity activities within the meaning of Section 9(5) of the ITA. As a conclusion, Finnish private equity funds are able to meet the condition on private equity activities by carrying on private equity activities in real estate sector and fund of funds investment activities in addition to the traditional private equity activities described above.

4.3.2 Alternative Investment Funds

In 2019, Section 9(5) of the ITA was amended in connection with the enactment of Section 9(6) of the ITA. The current Section 9(5) of the ITA imposes a new condition on Finnish private equity funds for the application of the special tax treatment to their foreign investors. The new condition requires the limited partnership carrying on private equity activities to be an alternative investment fund under the AIFM Act. In other words, the scope of application of Section 9(5) of the ITA is restricted to only cover those limited partnerships carrying on private equity activities that are alternative investment funds under the AIFM Act[337].

The term '*alternative investment fund*' is defined in Section 1 of Chapter 2 of the AIFM Act. The provision stipulates that an alternative investment fund means a corporate entity or other type of collective investing activities where funds are raised from a number of investors with a view to investing them in accordance with a defined investment policy for the benefit of the investors without a need for an authorisation by virtue of Article 5 of the UCITS Directive. Based on the preparatory works of the current Section 9(5) of the ITA, EuVECA[338], EuSEF[339], and ELTIF[340] funds as well as closed-end alternative investment funds covered by Section 2 of Chapter 23 of the AIFM Act are treated as alternative investment funds within the meaning of the special provision[341].

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337 Government Proposal 306/2018 vp, p. 18.

338 European venture capital funds are registered under Regulation (EU) No 345/2013 of the European Parliament and the Council of 17 April 2013 on European venture capital funds.

339 European social entrepreneurship funds are registered under Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds.

340 European long-term investment funds are registered under Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds.

341 The last-mentioned funds are funds established before the AIFM Act entered into force and are subject to a transitional provision. See Government Proposal 306/2018 vp, pp. 18–19.

The law amending Section 9 of the ITA entered into force on 20 March 2019 and is applied for the first time in the current tax year 2019[342]. In practice, many limited partnerships carrying on private equity activities are also alternative investment funds under the AIFM Act[343]. The amendment of Section 9(5) of the ITA does not have any impact on such Finnish private equity funds. Since the special tax treatment may also have been applied to foreign investors in Finnish private equity funds not considered as alternative investment funds within the meaning of Section 9(5) of the ITA[344], the new condition is subject to a transitional period of five years[345]. However, one should note that the transitional period only applies to Finnish private equity funds registered before 20 March 2019.[346] In other words, all Finnish private equity funds registered after the entry into force of the new law have to be alternative investment funds under the AIFM Act in order to fulfil the alternative investment fund condition laid down for Finnish private equity funds.

4.3.3 Concerns

Both the original and current Section 9(5) of the ITA require Finnish private equity funds to meet two conditions for the purpose of applying the flow-through tax treatment to income received through the funds. Firstly, Finnish private equity funds have to be formed as limited partnerships. Secondly, the funds may only be engaged in private equity activities. As observed, the partnership agreement of the funds must stipulate that the purpose of the partnerships is to conduct private equity activities, and the partnerships *de facto* conduct them as their sole purpose. Moreover, the current Section 9(5) of the ITA requires Finnish private equity funds to be alternative investment funds under the AIFM Act.

Since the fulfilment of the first condition is rather evident in respect of Finnish private equity funds formed as limited partnerships, the main emphasis is on the other two conditions. Prior to the legal praxis clarifying private equity activities, the lack of a statutory definition of private equity activities was criticised as it gave rise to legal uncertainty for taxpayers[347]. In an interview, *Mikkola* emphasised that since a more precise meaning of the concept has

342 Government Proposal 306/2018 vp, p. 23.
343 Government Proposal 94/2013 vp, p. 104; Government Proposal 17/2015 vp, p. 10; and Government Proposal 306/2018 vp, p. 15. See also Järvinen 2019, p. 182.
344 See Järvinen 2019, p. 182.
345 In other words, the requirement of applying the AIFM Act will be applicable for the first time in the tax year 2024. See Government Proposal 306/2018 vp, p. 19.
346 Government Proposal 306/2018 vp, p. 23.
347 See, e.g., Viitala 2005, p. 516.

already been defined in legal praxis, there is currently no need for a statutory definition for private equity activities.[348]

A similar view was taken by *Jokitie* and *Vehviläinen*. In addition to referring to the clarifying legal praxis, they pointed out that defining the concept of private equity activities with sufficient accuracy could be challenging.[349] These remarks are relevant and accurate. Even though a lack of statutory definitions generally creates legal uncertainty, it is worth noting that this way there is more room for interpretation, and thus the definition may be further developed more widely in future legal praxis. As a conclusion, it may be even more desirable for market actors that the definition of private equity activities has some room for interpretation.

All in all, the common view seems to be that private equity activities are sufficiently defined in legal praxis and there is no need to add a statutory definition in the Finnish tax laws. Another question, however, is whether or not the special provision promotes neutrality in Finnish tax legislation. In judicial literature, *Juusela* has suggested that the condition should be abolished for the sake of tax neutrality. According to him, the special tax regime places companies carrying on private equity activities in a better position comparing to companies engaging in other business activities.[350] Moreover, one could even argue that the special provision is incompatible with EU law as it could be deemed to be discriminative[351] or even forbidden state aid under the TFEU[352]. However, as long as the special tax regime is not deemed to violate EU law, amendments in this regard are unlikely to be adopted.

With regard to the alternative investment fund condition imposed on Finnish private equity funds in connection with the amendment of Section 9(5) of the ITA in 2019, the main concern in the course of the amendment process related to the transitional period of five years. The duration of the transitional period was under scrutiny as some commentators of the draft version of the government proposal considered that the transitional period should

[348] Interview with Mikkola 2019.
[349] Interview with Jokitie 2019; and Interview with Vehviläinen 2019.
[350] Juusela 2007, p. 102.
[351] Without going further into details, *Lehtimaja* has evaluated whether or not the special provision only applicable to Finnish limited partnerships is in line with non-discriminatory provisions of EU law and tax treaties. As an example, foreign private equity funds having a permanent establishment in Finland would be placed in an unequal position. See more in Lehtimaja 2006, pp. 49–50.
[352] If the special tax treatment granted for foreign investors investing through Finnish limited partnerships carrying on private equity activities is considered to be a tax incentive that discriminates cross-border economic operators, it may be considered as an distortion of competition prohibited by Sections 107, 108, and 109 of the TFEU. See more about the relation of national tax measures and forbidden state aid in Terra – Wattel 2019, p. 110.

be ten years in order to mitigate negative impacts caused by the amendment to pre-existing Finnish private equity funds[353]. Since the partnership period of Finnish private equity funds is often agreed to be ten years, a longer transitional period would have enabled foreign investors in Finnish private equity funds not treated as alternative investment funds under the AIFM Act to continue benefitting from the special tax treatment until the end of the funds' lifespan.

However, the Finnish government considered that a transitional period of five years is sufficient when taking into account the fact that Finnish private equity funds are usually formed for a fixed term. The preparatory works further stipulate that the transitional period provides enough time for private equity funds to adapt to the new legal requirements. Furthermore, many private equity funds are likely to come to end of their partnership period during the following five years.[354] Even though the length of the transitional period has been slightly criticised, the new requirement included in Section 9(5) of the ITA has been perceived clarifying the scope of application of the special provision[355].

As a result of adopting the new condition, Finnish private equity funds that have investors willing to benefit from the special tax treatment are no longer regulated solely by the Partnership Act and general contractual rules. In addition to these rules, they have to take into account the AIFM Act. In respect of many funds, the AIFM Act has been applied as of the year 2014. However, there are still some funds that are not yet required to follow the rules of the AIFM Act. Without going into greater details in the regulatory obligations, the legislative amendment may increase the amount of administrative work in funds that are not yet alternative investment funds as they are required to meet the new condition by the year 2024 and onwards[356].

According to *Vehviläinen*, the new condition might be problematic for Finnish private equity funds not carrying on private equity activities regulated by the AIFM Act. Such funds are, for instance, micro-funds that are smaller funds not conducting marketing falling into the

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[353] Comments of the FVCA 2018, p. 3; Comments of the Finnish Bar Association 2018, p. 5; and Comments of the Finnish Tax Experts 2018, p. 3.
[354] Government Proposal 306/2018 vp, p. 15.
[355] In the interviews, this standpoint was taken by all interviewees. Interview with Jokitie 2019; Interview with Mikkola 2019; Interview with Santavirta 2019; and Interview with Vehviläinen 2019. See also Comments of the FVCA 2018, pp. 2–3; Comments of the Finnish Bar Association 2018, p. 5; and Comments of the Finnish Tax Experts 2018, p. 3.
[356] The growing amount of administrative work following from the new special condition was also recognised by *Vehviläinen*. Interview with Vehviläinen 2019.

scope of application of the law[357] and publicly funded private equity funds not looking for investors in the financial markets.[358] In other words, private equity activities and activities regulated by the AIFM Act are only partially overlapping. Since there are private equity funds carrying on private equity activities not regulated by the AIFM Act, such funds having foreign investors as limited partners might fall between two stools. This is due to the fact that the funds have to choose whether or not they are ready to comply with new rules in order for their investors to retain their eligibility to the special tax treatment.

The extension of the application of the AIFM Act to these kinds of funds might have been slightly too excessive as micro funds were explicitly excluded from the scope of application of the AIFM Act[359]. Hence, one might ask whether or not it was necessary to include the alternative investment fund condition in Section 9(5) of the ITA instead of Section 9(6) of the ITA. In this scenario, only Finnish private equity funds having funds of funds as limited partners would have to be alternative investment funds[360]. This way the original special provision would still be applied in the same manner as previously. In other words, all foreign investors meeting the conditions of the original special provision could benefit from the special tax regime also in the future.

4.4 Special Provisions and Foreign Investors

4.4.1 Limited Partners or Persons Subject to Limited Tax Liability

For the purpose of benefitting from the special tax treatment, foreign investors in Finnish private equity funds are also required to fulfil certain criteria. This Subchapter 4.4 is dedicated to analysing these criteria and addressing challenges related to their satisfaction. As observed, foreign investors may be either direct or indirect investors in Finnish private equity funds. In case of direct investments, Section 9(5) of the ITA requires that foreign investors are limited partners subject to limited tax liability in Finland. In turn, foreign investors investing indirectly in Finnish private equity funds have to be persons subject to limited tax liability under Section 9(6) of the ITA.

[357] See Government Proposal 94/2013 vp, p. 63.
[358] Interview with Vehviläinen 2019.
[359] Government Proposal 94/2013 vp, p. 63.
[360] Considering the operations of such funds, they would most probably be alternative investment funds in any case. Therefore, the inclusion of the new condition in Section 9(6) of the ITA could have been deemed to be more justifiable considering the objectives of the AIFM Act.

As observed in Chapter 3, non-resident individuals and foreign corporate entities, *id est* companies incorporated abroad or otherwise established under laws of a foreign state, are subject to limited tax liability in Finland. Therefore, only foreign investors treated as non-resident individuals or foreign corporate entities for Finnish tax purposes may be able to benefit from the special tax treatment. Since only legal entities that are deemed to be corporate entities under Finnish tax laws may fulfil the condition requiring limited tax liability in Finland, legal entities treated as partnerships for Finnish tax purposes cannot fall into the scope of application of the special tax regime[361].

In addition to the condition requiring limited tax liability in Finland, Section 9(5) of the ITA demands that foreign investors investing directly in Finnish private equity funds are limited partners in a limited partnership carrying on private equity activities. Therefore, foreign investors have to be limited partners within the meaning of Section 9(5) of the ITA in order enjoy the special tax treatment. It is essential to note that neither the law itself nor its preparatory works define the term '*limited partner*'. In Finnish legislation, the term is only defined in Section 1 of Chapter 1 of the Partnership Act. Based on judicial literature, private law concepts are generally used in tax law with the same meaning as they have in private law[362]. Therefore, the interpretation is based on the private law meaning of the term.

In accordance with Sections 1(2) and 1(3) of Chapter 1 of the Partnership Act, a limited partner in a limited partnership is a partner whose liability is limited to the amount of their capital payments agreed upon in the partnership agreement. A general partner is, in turn, any other partner than a limited partner, by virtue of Section 1(3) of Chapter 1 of the Partnership Act. Accordingly, the special tax treatment only applies to limited partners. In the light of the systematics of the Partnership Act, Section 9(5) of the ITA cannot be applied to a general partner who is personally liable for debts and obligations of the partnership as if they were its own.

Where the limitation on the scope of application of Section 9(5) of the ITA to limited partners is clear and unambiguous[363], the wording of the special provision has been under scrutiny in legal praxis. As previously observed in Subchapter 3.4, Section 9(5) of the ITA

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361 As a comparison, if Section 9(5) of the ITA only required foreign investors to be non-resident limited partners, foreign partnerships would also satisfy the condition as they are not treated residents under Finnish tax laws.
362 This view is commonly shared among academic legal scholars in Finland. See, e.g., Kilpi 1952, p. 10; Klami 1981, p. 394; and Vesanen 1981, pp. 83–89. For a thorough analysis on the Finnish discussion on the use of private law concepts in tax law, see Järvenoja 2013, pp. 139–163.
363 See Viitala 2007, p. 15.

was deemed to be inapplicable to foreign investors investing in Finnish private equity funds through a fund of funds[364]. On the basis of the literal interpretation of the special provision, foreign investors investing indirectly in Finnish private equity funds through funds of funds were not held as limited partners of the funds within the meaning of Section 9(5) of the ITA. As a result, these investors were not able to benefit from the special tax treatment in Finland.

As of the year 2019, foreign investors investing indirectly in Finnish private equity funds through funds of funds have been able to benefit from the special tax regime under Section 9(6) of the ITA. As an interesting remark, the new special provision leaves room for interpretation in respect of foreign investors. Due to the fact that foreign investors are only required to be persons subject to limited tax liability in Finland, a literal interpretation of the provision would lead to a conclusion that they are not, in fact, required to be limited partners in a fund of funds through which they invest in Finnish private equity funds.

Although this study focuses merely on analysing the tax treatment of foreign investors in Finnish private equity funds, it is worth noting that the wording of the new special provision does not rule out the possibility that non-resident individuals and foreign corporate entities acting as general partners could also benefit from the special tax regime[365]. The preparatory works state that the new special provision does not refer to limited partners because the share to the income of a limited partnership engaged in private equity activities is indirect[366]. However, there is no mention on the purpose of extending the scope of application of the special tax regime to general partners[367].

The application of the special tax regime to general partners would, however, be possible solely in fund of funds structures. The underlying reason for this is that Section 9(5) of the ITA demands foreign investors to be limited partners subject to limited tax liability, whereas Section 9(6) of the ITA merely refers to persons subject to limited liability. As a conclusion,

[364] See KVL 67/2011, confirmed by SAC 2013 T 283; and KVL 34/2018, confirmed by SAC 2019 T 1934.
[365] See Government Proposal 306/2018 vp, p. 17.
[366] According to *Jokitie*, some suggestions for the wording of Section 9(6) of the ITA were very precise, and after weighing different suggestion against each other, the FTA recommended a general term, such as '*persons subject to limited tax liability*', to be chosen. Interview with Jokitie 2019.
[367] With regard to objectives of the new special provision, the preparatory works state that the amendment aims at enabling the application of the flow-through tax treatment granted by Section 9(5) of the ITA also when investments are channelled through certain fiscally transparent structures. This objective would not speak for the interpretation that the application of the special tax regime is extended to also cover general partners in funds of funds. However, the literal interpretation of the wording of Section 9(6) of the ITA would be in line with the other objectives of the legislative change, as the broader scope of application of the special tax regime is likely to improve the competitiveness of and remove obstacles from receiving foreign capital into Finnish private equity funds.

on the basis of the wording of Section 9(6) of the ITA, the scope of application of the new special provision could, in fact, be deemed to be broader in respect of partners compared to Section 9(5) of the ITA.

4.4.2 Applicable Tax Treaty

The geographical scope of application of the special tax regime is restricted to foreign investors residing in a state that has an ongoing tax treaty with Finland[368]. The exact same prerequisite is laid down in both Section 9(5) and Section 9(6) of the ITA. Therefore, both direct and indirect foreign investors in Finnish private equity funds have to be residents in Finland's tax treaty state. In other words, foreign investors other than the ones residing in a state with whom Finland has concluded a tax treaty cannot benefit from the special tax treatment granted by Section 9(5) of the ITA, and Section 9(6) of the ITA in relation to fund of funds structures.

The limitation of the scope to residents of tax treaty states was first justified by anti-evasion reasons[369]. In connection with the enactment of Section 9(6) of the ITA and amendment of Section 9(5) of the ITA, the international tax surveillance aspect was supplemented by the rationale of tax treaties dividing the taxing rights between the contracting states[370]. Since Finland has given up its right to tax certain non-resident partners in Finnish limited partnerships carrying on private equity activities, the limitation of the geographical scope of application to tax treaty states has been regarded to be justifiable[371].

As observed in Chapter 3, tax treaties usually apply only to a person who is a resident of one or both of the contracting states[372]. Therefore, foreign investors in Finnish private equity funds have to always be classified for both Finnish tax purposes and tax treaty purposes. If a foreign investor is regarded to be a resident person of a state with whom Finland has concluded a tax treaty, the special tax treatment is applied provided that other conditions laid

[368] Currently, Finland has concluded a tax treaty with almost 80 states. See all Finland's existing tax treaties in Guidance of the FTA on Tax Treaties.
[369] Government Proposal 64/2005 vp, p. 6. See also Government Proposal 306/2018 vp, p. 12.
[370] Government Proposal 306/2018 vp, p. 12.
[371] The working group analysed the possibility of removing the condition requiring tax treaty residency from foreign investors investing in Finnish private equity funds through funds of funds. In the analysis, they ended up in a conclusion that the limitation of the scope of application of the special treatment to tax treaty residents is still justifiable. This standpoint was approved by the Finnish government in connection with the amendment of Section 9 of the ITA. As a result, the geographical scope of application was not amended in this regard. See more in Ministry of Finance publications 14/2018, pp. 176–177 and Government Proposal 306/2018 vp, pp. 12–13.
[372] Article 1 of the OECD Model. See more in Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax residence.

down in Section 9(5) of the ITA, and Section 9(6) of the ITA in respect of fund of funds structures, are met. In turn, the special tax regime cannot be applied to legal entities that are not treated as tax treaty subjects under the tax treaty concerned as such entities may not enjoy the tax treaty benefits.

Even if a company is considered a corporate entity under Finnish tax laws, it is possible that the company is not treated as a tax treaty subject under the tax treaty concerned. This was the case in SAC 2004:116 where a Luxembourg *Fonds Commun de Placement* was treated as a corporate entity under Finnish domestic tax laws but not resident under the tax treaty concluded between Finland and Luxembourg. In the light of the foregoing considerations, the Luxembourg *Fonds Commun de Placement* would not have been able to benefit from the special tax treatment because it would not have met the tax treaty condition imposed on foreign investors by the special tax regime[373].

As a comparison, the SAC has also evaluated the tax treaty eligibility of another Luxembourg legal entity. In the ruling, SAC 2004:111, the SAC held that a Luxembourg *Société d'investissement à Capital* was a tax treaty resident. Thus, the company was entitled to invoke the tax treaty concluded between Finland and Luxembourg. Even the fact that the company was exempt from corporate tax under Luxembourg law did not constitute an obstacle to its eligibility for tax treaty benefits. Since the Luxembourg *Société d'investissement à Capital* would have met the tax treaty condition imposed on foreign investors, the special tax treatment would have been granted to the company provided that also other conditions laid down in the special provision(s) had been satisfied.[374]

4.4.3 Concerns

The preceding sections clarified the conditions imposed on foreign investors wishing to benefit from the special tax treatment provided by Sections 9(5) and 9(6) of the ITA. It was noted that Section 9(5) of the ITA requires foreign investors investing directly in Finnish private equity funds to be limited partners subject to limited tax liability, whereas Section

[373] Subchapter 4.5 addresses the question whether or not the company and its investors would have been able to benefit from the special tax treatment on the basis of Section 9(6) of the ITA.

[374] In this respect, one should note that even though Sections 9(5) and 9(6) of the ITA require that Finland and the state of residence of foreign investors have concluded a tax treaty, such tax treaty does not necessarily determine the tax treatment of income derived through the partnership. In triangular situations where income is derived from a third state, the tax treaty between the original source state of income and the residence state of each investor determines the tax treatment of such income. However, when income is received from Finnish sources, the tax treaty between Finland and the state of residence of each investor is obviously applied.

9(6) of the ITA merely demands foreign investors investing indirectly in Finnish private equity funds to be persons subject to limited tax liability. Since it is not perfectly clear whether or not the special tax treatment could also be applied to general partners in funds of funds investing in Finnish private equity funds, some legal uncertainty relates to the application of the new special provision.

Prior to the case law of the SAC regarding the non-applicability of Section 9(5) of the ITA on fund of funds structures, some concerns were raised in relation to the tax treaty condition. Instead of being worried about the literal interpretation of Section 9(5) of the ITA, the main concern regarded the fact that since funds of funds are typically established as limited partnerships that are not tax treaty subjects, the application of the special provision would require Finnish private equity funds to determine the state of residence of each of their direct and indirect investors[375]. It is interesting to observe that the concern has, in fact, become the real issue only now.

Moreover, the determination of the state of residence of each investor is necessary for the withholding taxation purposes. As observed in Chapter 3, Finnish private equity funds are obliged to levy withholding tax on dividend income received by persons benefitting from the special tax treatment. In order to withhold a correct amount of tax each year, Finnish private equity funds are obliged to keep track on each of their investors on an annual basis. This is due to the fact that the application of EU law and tax treaties may significantly affect the tax treatment of foreign investors enjoying the benefits of these regimes.

For the reasons set above, Finnish private equity funds have to be constantly aware of the residence of their investors. The FTA requires foreign investors acting as limited partners in Finnish private equity funds to submit a copy of the partnership agreement of the Finnish private equity fund concerned and certificate of residence in order to prove that they are entitled to the special tax treatment granted by Section 9(5) of the ITA. The starting point is that the general partner of the fund provides the FTA with all information needed in

[375] See, e.g., Svennas – Makkonen 2005, p. 105; Tähtinen – Juusela 2006, pp. 15–18; Lehtimaja 2006, pp. 44–45; Viitala 2007, p. 33; and Juusela 2007, p. 101.

connection with reporting the information on its partners[376].[377] However, one should note that foreign investors may submit the required evidence to the FTA also by themselves.

In fund of funds structures, foreign investors are also required to provide the FTA with documents indicating that they are eligible for the special tax treatment. In order to benefit from the special tax treatment, foreign investors are obliged to submit a clarification on their shares in all funds of funds and shares of these funds of funds in the Finnish private equity fund concerned. Accordingly, the clarification is required in respect of each level of the fund structure. Furthermore, the FTA demands foreign investors to provide a certificate of their tax treaty residence.[378] The special tax regime cannot be applied unless all necessary information is provided. Consequently, the taxation of so called unidentified foreign investors is carried out in accordance with the Act on Assessment Procedure.[379]

Finnish private equity funds might face challenges in determination of the state of residence of their investors in respect of fund of funds structures where funds of funds are not allowed or willing to provide information on their investors[380]. In judicial literature, *Juusela* has noted that the refusal may result from a statutory disclosure prohibition[381]. Even if there is no statutory or contractual disclosure prohibition, funds of funds may decide not to provide information on their investors on the grounds of other reasons. According to *Santavirta*, funds of funds might not be willing to provide information on their investors, for example, due to the fact that they do not want to disclose their investor base to third parties[382]. In these cases, the only remaining option is that foreign investors themselves provide all information needed for the tax assessment purposes.

In judicial literature, *Juusela* has suggested that the issue could be solved by abolishing the tax treaty condition. This way dividends would still be subject to withholding taxation, and the amount of withholding tax would depend on the fact whether or not the funds of funds

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[376] Business partnerships were previously required to submit a supplement form, business partnership's information statement of shareholders, but as of 2018, information on partners has been reported on the tax return. If there are more than four partners in a business partnership, a supplement form is required to be used. See more in Guidance of the FTA on 6A Business Tax Return.
[377] Government Proposal 64/2005 vp, p. 8.
[378] Government Proposal 306/2018 vp, p. 18. Even though the preparatory works of Section 9(6) of the ITA do not explicitly mention that the partnership agreement of each fund is requires for the purpose of showing foreign investors shares in funds' profits, these agreements will most probably be demanded also in connection with fund of funds structures.
[379] Section 16(2) of the Act on Taxation of Non-residents. See Government Proposal 306/2018 vp, p. 18.
[380] See Lehtimaja 2006, p. 45; and Viitala 2007, p. 33.
[381] See Juusela 2007, p. 100.
[382] Interview with Santavirta 2019.

provide the necessary information on their investors to Finnish private equity funds. If the funds of funds were not willing or could not provide the required information, tax on dividend income received by such investors would be withheld at the normal rate of 20%.[383] Hence, the lack of the required information would only affect the investors' possibility to obtain tax treaty benefits. The abolishment of the tax treaty condition is, however, unlikely to happen, at least for the time being, as the geographical scope of application has only recently been deemed to be justifiable.

In addition to the tax surveillance aspects and rationale of tax treaties, the tax treaty condition could be considered to be justifiable also from the perspective of avoiding the incidence of double non-taxation. A double non-taxation situation takes place if neither the source state nor the state of residence of the foreign investors levy tax on these income items derived through the fund[384]. Taking into account that states have different kinds of domestic tax laws and tax treaty networks and tax treaty provisions may significantly differ between tax treaties, it is possible that the application of the special tax regime might already now lead to double non-taxation[385]. Obviously, there is always a risk that some investors might use Finnish private equity funds in their investment activities only for the purpose of benefitting from potential legal loopholes.

4.5 Special Provisions and Funds of Funds

4.5.1 Finnish or Foreign Partnerships

If foreign investors invest in Finnish private equity funds through one or several funds of funds, each fund of funds is also required to meet certain conditions in order for their investors to benefit from the special tax regime in Finland. All conditions imposed on funds of funds are included in Section 9(6) of the ITA. This part of the study scrutinises the criteria that funds of funds with foreign investors willing to benefit from the special tax treatment are required to fulfil. Moreover, potential challenges related to the satisfaction of the conditions are presented in the end of this Subchapter 4.5.

[383] See Juusela 2007, p. 100.

[384] For more thorough analysis on the concept of double non-taxation and potential reasons behind it, see Parada 2018, pp. 15–22.

[385] Since the special tax regime disregards a permanent establishment of foreign investors for Finnish tax purposes under certain circumstances, it is possible that some states that have a tax treaty with Finland consider that only Finland has the right to tax certain income items derived through Finnish private equity funds. If these income items are not subject to tax in Finland when the special provision is applied, such items might become subject to double non-taxation.

First of all, funds of funds have to be considered either Finnish or foreign partnerships for Finnish tax purposes. If the funds of funds are deemed to be foreign, they must be registered in or established under laws of such a jurisdiction with whom Finland has agreed on the exchange of information in tax matters between authorities. At first, one should pay attention to the wording of Section 9(6) of the ITA. The provision stipulates that what is provided in Subsection 5 is also applied to a person subject to limited tax liability when the part of the income referred to in the subsection corresponding to the person's share composes of income shares from one or several *Finnish or foreign partnerships*. It is essential to note that the provision does not require that the funds of funds are treated as Finnish limited partnerships in the same way as Finnish private equity funds. Instead, the funds of funds may be any kinds of partnerships under Finnish tax laws.

Section 4 of the ITA sets forth legal entities that are treated as partnerships for Finnish tax purposes. First of all, general and limited partnerships are treated as partnerships under Section 4 of the ITA. In addition, other similar entities that are formed by two or more persons for the purpose of conducting business jointly on behalf of these persons for cultivating or holding immovable property are regarded as partnerships for Finnish tax purposes. Moreover, companies of ship owners (*laivanisännöintiyhtiö* in Finnish) are partnerships within the meaning of Section 4 of the ITA. However, joint ventures formed by two or more taxpayers engaged in business activities for performing a specified construction work or other similar work are not treated as partnerships in Finland[386].

There are no rules in Finnish tax legislation governing when a partnership is regarded to be Finnish. In taxation practice, general and limited partnerships are treated as Finnish partnerships if they have been registered or otherwise established under Finnish laws[387]. In turn, if a partnership is registered abroad or established under the laws of a foreign state, the partnership is deemed to be foreign. Similarly to corporate entities, partnerships established under foreign laws will be foreign even if their partners are Finnish resident nationals[388]. However, one should note that contrary to corporate entities, some partnerships might not be registered in any state. With respect to these kinds of unregistered partnerships, the place

[386] Section 4(2) of the ITA.
[387] Nykänen 2015, p. 122; and Andersson – Linnakangas – Frände 2016, p. 71.
[388] Nykänen 2015, p. 122; and Helminen 2019, Chapter 5, Unlimited and Limited Tax Liability and Tax residence, Unlimited and Limited Tax Liability, Companies and Estates of a Deceased Person, Partnerships.

of management and centre of activities become relevant when determining the partnership state[389].

As noted in Chapter 3, simply the fact that a legal entity is treated as a separately taxable entity or fiscally transparent entity in the state where it is established does not automatically mean that it will have the same classification in Finland. This was the case in the SAC's ruling, SAC 2004:116, in which the Luxembourg *Fonds Commun de Placement* was treated as a corporate entity for Finnish tax purposes although it was considered as a fiscally transparent entity in Luxembourg. Since Section 9(6) of the ITA requires that each fund of funds is treated as a partnership under Finnish tax laws, companies formed as *Fonds Communs de Placement* and other legal entities that are treated as corporate entities in Finland but fiscally transparent entities in the state where they were established cannot benefit from the special tax treatment on the basis of the special provision[390].

Based on the wording of Section 9(6) of the ITA, the number of funds of funds is not limited in the special tax regime. Therefore, there may be as many funds of funds formed as partnerships between the Finnish private equity fund concerned and ultimate foreign investors as are needed. However, one should note that each fund of funds is required to meet all conditions laid down for funds of funds in Section 9(6) of the ITA. In other words, all funds of funds have to be Finnish or foreign partnerships within the meaning of Section 4 of the ITA. Additionally, all funds of funds treated as foreign partnerships are required to meet the geographical condition analysed in the following section.

4.5.2 Applicable Agreement on Information Exchange

The above-mentioned geographical condition refers to the second condition that foreign funds of funds must meet for the purpose of applying the special tax regime in fund of funds structures. Pursuant to Section 9(6) of the ITA, if a foreign investor uses one or several foreign partnerships as funds of funds when investing in a Finnish private equity fund, each one of these foreign partnerships is required to be registered in or established under laws of

[389] SAC 1971 T 5016. See Nykänen 2015, p. 122; and Andersson – Linnakangas – Frände 2016, p. 71.
[390] The preparatory works explicitly confirmed this standpoint in respect of companies formed as *Fonds Communs de Placement*. See Government Proposal 306/2018 vp, p. 14. However, if these so called hybrid entities are treated as investment funds under Section 3 of the ITA, they can invest in Finnish private equity funds without tax consequences in Finland on the basis of Section 20a of the ITA. See the KVL's decisions, KVL 8/2013 and KVL 14/2013, where Luxembourg companies formed as *Fonds Communs de Placement* were treated as investment funds. Otherwise, such funds of funds are not able to make tax efficient investments in Finnish private equity funds.

such a jurisdiction with whom Finland has agreed on the exchange of information in tax matters between authorities. In this respect, it is essential to note that the other geographical condition, *id est* the tax treaty condition, must be simultaneously met by foreign investors in fund of funds structures. Hence, the geographical scope of application of the new special provision is twofold.

The wording of Section 9(6) of the ITA implies that there is no specific agreement that Finland should have concluded with the fund of funds jurisdiction[391]. Instead, the decisive factor is whether or not Finland has agreed on the exchange of information in tax matters between authorities. The preparatory works specify that the agreement between Finland and the state where the fund of funds is located must enable the exchange of information on request[392]. Based on the preparatory works, the exchange of information within the meaning of Section 9(6) of the ITA takes place between the EU Member States on the basis of the Administrative Cooperation Directive[393].

Accordingly, a tax treaty or another agreement on the exchange of information in tax matters between authorities is not required in respect of foreign funds of funds located in other EU Member States. In practice, this means that even if Finland terminates a tax treaty with another EU Member State, the fund of funds registered in or established under laws of such EU Member State may still meet the conditions imposed on it by Section 9(6) of the ITA owing to the Administrative Cooperation Directive. Hence, the termination of a tax treaty in such situation does not affect the application of the special tax regime to foreign investors provided that the investors do not reside in the EU Member State where the fund of funds is located[394].

With regard to other states and jurisdictions, the preparatory works state that the exchange of information within the meaning of Section 9(6) of the ITA could be based on an extensive tax treaty, separate tax information exchange agreement, or the Convention on Mutual Administrative Assistance in Tax Matters[395]. It should be noted that the preparatory works explicitly refer to extensive tax treaties instead of merely referring to tax treaties in general.

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391 In this thesis, the jurisdiction where a fund of funds is registered or under whose laws it is otherwise established is referred to as the fund of funds jurisdiction.
392 See Government Proposal 306/2018 vp, p. 16.
393 See Government Proposal 306/2018 vp, p. 16.
394 This is due to the fact that investors residing in a state with whom Finland does not have an ongoing tax treaty are not able to satisfy the tax treaty condition imposed on them. However, investors residing in states with whom Finland has an ongoing tax treaty may benefit from the special tax treatment provided that all other conditions imposed on Finnish private equity funds, foreign investors, and funds of funds are met.
395 See Government Proposal 306/2018 vp, p. 16.

This is due to the fact that tax treaties may be divided into extensive tax treaties including a provision on the exchange of information and limited tax treaties not including such provision[396]. Accordingly, the latter tax treaties do not qualify as agreements on the exchange of information within the meaning of Section 9(6) of the ITA.

As observed, the sufficient exchange of information could also be based on a tax information exchange agreement or the Convention on Mutual Administrative Assistance in Tax Matters. In August 2019, Finland has concluded a tax information exchange agreement with over 40 jurisdictions[397]. Moreover, almost 130 jurisdictions have signed the Convention on Mutual Administrative Assistance in Tax Matters[398]. Therefore, the geographical area where funds of funds may be registered or otherwise established is significantly wider compared to the area where foreign investors may reside in order to benefit from the special tax treatment[399].

In conclusion, funds of funds located outside the EU have to be established in a jurisdiction with whom Finland has concluded an extensive tax treaty or tax information exchange agreement. Alternatively, the jurisdiction may have signed the Convention on Mutual Administrative Assistance in Tax Matters. In the light of the foregoing considerations, if Finland has concluded a limited tax treaty with the fund of funds jurisdiction, but has also agreed on the exchange of information in tax matters between authorities with that jurisdiction within the meaning of Section 9(6) of the ITA, the special tax regime may be applied provided that other conditions laid down in the special provisions are met. As a concluding remark, the wording of Section 9(6) of the ITA makes it possible for future agreements and instruments granting the exchange of information on request to qualify as

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396 The FTA noted in its comments on the draft proposal that the government proposal should include the term '*extensive tax treaty*' (*laaja verosopimus* in Finnish) in order to clarify the scope of application of the new special provision. See Comments of the FTA 2018, p. 3.

397 See Document on the Status of Finland's Tax Treaties of the Finnish Ministry of Finance 2019.

398 See News of the OECD 2019.

399 If the geographical area where funds of funds may be registered or otherwise established was limited to the EU Member States or/and states with whom Finland has concluded an extensive tax treaty, all investors using funds of funds not located in the above-mentioned area would not have been able to benefit from the special tax regime. For instance, all funds of funds located in British Virgin Islands, Cayman Islands, Guernsey, and Jersey would not have been able to meet the geographical condition as they are not located in the EU nor has Finland concluded an extensive tax treaty with them. According to *Santavirta*, most of the largest US and Chinese private equity investors use funds of funds in their investments in European private equity funds. These funds of funds are primarily located in the above-mentioned islands. Interview with Santavirta 2019. Accordingly, the current formulation of the geographical scope of application is crucially important for these investors as Finland has concluded the required tax information exchange agreements in addition to limited tax treaties with them. If the new special provision had stipulated that funds of funds have to be located in the EU or above-mentioned tax treaty states, all large investors solely using funds of funds located in these islands, or other jurisdictions with whom Finland does not have a valid extensive tax treaty and which are not located in the EU, would have been indirectly restrained from investing in Finnish private equity funds.

agreements on the exchange of information in tax matters within the meaning of the new special provision.

4.5.3 Concerns

To sum up, the application of the special tax treatment to foreign investors investing in Finnish private equity funds through one or several funds of funds requires some conditions to be fulfilled at each level of the fund structure. This means that also funds of funds used as investment vehicles have to meet certain criteria. First of all, each fund of funds has to be classified as a partnership under Finnish tax laws. In addition, if one or several funds of funds are deemed to be foreign partnerships, such funds are required to be either registered in or established under laws of such a jurisdiction with whom Finland has agreed on the exchange of information in tax matters between authorities.

The requirement regarding the classification of foreign legal entities as partnerships was under scrutiny during the recent legislative process. The Finnish Bar Association tried to convince the government to include the term '*other fiscally transparent entities*' within Section 9(6) of the ITA[400]. In the end, the term was not implemented in the special provision as it was not proved to deliver added value to the classification of foreign legal entities[401].

The suggestion of the Finnish Bar Association should not, however, be fully ignored as it highlights the problem related to the application of the new special provision. As observed, companies formed as *Fonds Communs de Placement* do not meet the conditions laid down for foreign investors or funds of funds. This means that foreign investors are not able to make tax efficient investments in Finnish private equity funds through *Fonds Communs de Placement* or other similar hybrid entities. Hence, these companies are placed in a less favourable position compared to Finnish funds of funds and other foreign funds of funds that are treated as fiscally transparent entities also for Finnish tax purposes.

Although a Luxembourg *Fonds Commun de Placement* is so far the only legal entity form that has been deemed to be opaque for Finnish tax purposes but fiscally transparent for tax treaty purposes, it is possible that some other foreign legal entities are similarly classified in the future. Such entities would end up falling outside the scope of application of the special tax regime similarly to *Fonds Communs de Placement*. From this perspective, the proposed new classification category could enable the application of the special tax treatment in fund

[400] See Comments of the Finnish Bar Association, pp. 3–4.
[401] Government Proposal 306/2018 vp, p. 14.

of funds structures where one or several funds of funds are hybrid entities similar to *Fonds Communs de Placement*.

However, *Santavirta* and *Vehviläinen* pointed out that, in spite of the good intentions, the amendment might not necessarily promote legal certainty. Both of them expressed concern about implementing a new classification category alongside the existing ones, because this would mean an introduction of a completely new term to the Finnish national legislation.[402] For the sake of clarity and predictability of the Finnish classification process, this standpoint is well-reasoned as the proposed amendment contains a risk of the process becoming unduly complex and unpredictable.

4.6 Conclusions

This part of the study provided a fundamental analysis on the application of the special provisions in respect of both direct and indirect investments in Finnish private equity funds. Moreover, the main concerns regarding the application of the special provisions were examined in great detail. Contrary to the preceding tax years, foreign investors are now able to make tax efficient investments both directly and indirectly in Finnish private equity funds. However, the application of the special tax treatment to foreign investors investing in Finnish private equity funds requires certain criteria to be met at each level of the fund structure.

With respect to Finnish private equity funds, Section 9(5) of the ITA demands them to be limited partnerships solely engaged in private equity activities. In addition, the funds that have been established after 20 March 2019 have to be alternative investment funds under the AIFM Act if their foreign investors wish to enjoy the special tax treatment. During the legislative process, the latter condition was under scrutiny only in respect of the transitional period. However, one should note that funds not engaged in activities governed by the AIFM Act are unduly excluded from the scope of application of the special tax regime.

As to foreign investors willing to benefit from the special tax regime, they are obliged to be either limited partners in Finnish private equity funds or persons subject to limited tax liability investing in Finnish private equity funds through one or several funds of funds. Moreover, each foreign investor wishing to enjoy the special tax treatment is required to reside in a state that has an ongoing tax treaty with Finland. For the purpose of applying the special tax regime, the FTA requires each foreign investor to prove that they are entitled to

[402] Interview with Santavirta 2019; and Interview with Vehviläinen 2019.

the special tax treatment in Finland. However, obtaining all necessary information might turn out to be challenging or even impossible in fund of funds structures.

Having regard to funds of funds, the new special provision demands them to be classified as partnerships under Finnish tax laws. If one or several funds of funds are deemed to be foreign, such funds are required to be either registered in or established under laws of such a jurisdiction with whom Finland has agreed on the exchange of information between authorities in relation to tax matters. A major source of uncertainty in respect of funds of funds is related to their classification as partnerships for Finnish tax purposes.

5 FINAL REMARKS

5.1 Concluding Remarks

The main purpose of this thesis has been to examine the tax treatment of income derived by foreign investors through Finnish private equity funds. Since private equity brings unique growth to the financial markets, the presumption of this thesis has been that private equity activities are worth promoting. For the purpose of creating better understanding of the attractiveness of Finnish legal and tax environment in the private equity sector, the research aimed to clarify the tax treatment of foreign investors in Finnish private equity funds in Finland. Since such investors may be subject to a special tax regime in Finland, the Finnish tax law provisions granting the special tax treatment have been analysed in great detail.

In order to truly understand the tax treatment of foreign investors in Finnish private equity funds, one should be aware of certain special characteristics of Finnish private equity funds. First of all, Finnish private equity funds are generally established as limited partnerships. As observed in Chapter 2, this legal form is preferred for private equity activities especially due to its flexibility and contractual freedom. Moreover, Finnish private equity funds are treated as fiscally transparent entities for Finnish tax purposes. This means that they are not considered as separate tax subjects in Finland. In taxation, their role is to solely function as accounting units to whom the total taxable income is computed.

After the computation at the fund level, the taxable income is allocated to the partners and taxed as their income. The income received by foreign investors through Finnish private equity funds primarily consists of capital gains received from disposals of shares in portfolio companies. As observed in Chapter 3, when the special tax regime is applied, most of the capital gains received by foreign investors are not taxable income in Finland. Only capital gains realised in connection with sales of immovable property in Finland and disposals of shares in companies whose assets primarily consist of immovable property situated in Finland are subject to tax in Finland. The taxation of such capital gains is assessed in accordance with the Act on Assessment Procedure, meaning that foreign investors are liable to file a tax return in Finland in respect of such income.

In addition to capital gains, foreign investors may receive dividends and interest through Finnish private equity funds. Since Finnish sourced interest income is generally exempt from tax in Finland when received by foreign investors, only Finnish sourced dividend income is taxable income for them in Finland. With regard to the tax assessment, Finnish private equity funds are obliged to withhold tax on taxable dividend and interest income received by foreign investors in accordance with relevant Finnish tax laws, EU law, and tax treaties.

The above-described combination of regular tax assessment and withholding taxation is applied to income received by foreign investors in Finnish private equity funds only on the condition that the special tax treatment is granted by Section 9(5) of the ITA, and Section 9(6) of the ITA in relation to fund of funds structures. As noted in Chapter 4, certain criteria have to be satisfied at each level of the fund structure. If foreign investors are not able to benefit from the special tax treatment due to fact that one or several conditions are not met, they will be liable to tax on all income received through Finnish private equity funds because such income will be deemed to be connected to a permanent establishment located in Finland. In this case, the investors are required to file a tax return in Finland as their taxation is fully assessed in accordance with the Act on Assessment Procedure.

The study revealed that Finnish private equity funds might face challenges when withholding tax on income received by their foreign investors. Since the funds have to be aware of the state of residence of each of their investors in order to withhold a correct amount of tax, they should be provided with adequate and up-to-date information on both their direct and indirect investors. In addition, the FTA requires foreign investors to provide a copy of the partnership agreement of the Finnish private equity fund concerned and certificate of residence in order to prove that they are entitled to the special tax treatment granted by the special tax regime. Moreover, indirect foreign investors should also submit a copy of the partnership agreement of each fund of funds used in the fund structure for the purpose of applying Section 9(6) of the ITA.

There is a risk especially in fund of funds structures that one or several funds of funds do not, for one reason or another, provide all information required regarding their investors for Finnish tax assessment purposes. Under these circumstances, the only remaining option is that foreign investors themselves provide all information needed to either Finnish private equity funds or directly to the FTA. If all required information on foreign investors is not submitted to the FTA, such investors may not benefit from the special tax treatment provided by the special tax regime. In this case, the investors are required to file a tax return in Finland as income received by them through the funds is subject to a regular tax assessment.

5.2 Discussion and *De Lege Ferenda* Analysis

In 2018, the FVCA reported that Finland was at risk of falling behind in drawing foreign capital into Finland[403]. As observed in Chapter 1, in 2017, only 30% of the investments in Finnish private equity funds were made by foreign investors, whereas the corresponding figure in Europe was on average 50% and in Sweden even 80%[404]. The difference in the percentage of foreign investments in Finnish and Swedish private equity funds can be expected to decrease during the forthcoming years. This prediction is partly a result from the enactment of the new special provision placing foreign investors' investments made through funds of funds in the same position with direct investments in Finnish private equity funds. Hence, the unnecessary barrier for fund of funds investments in Finnish private equity funds has been finally removed.

This study provided a comprehensive analysis of the conditions imposed on Finnish private equity funds, foreign investors, and funds of funds by the special tax regime. In the course of the research, some challenges related to the application of the special tax regime surfaced. For instance, the condition requiring all Finnish private equity funds to be alternative investment funds was questioned. With regard to the conditions laid down for foreign investors, the tax treaty condition has been under scrutiny already for years. Furthermore, some legal uncertainty still remains with the classification of foreign legal entities for Finnish tax purposes. This legal uncertainty affects both foreign investors and funds of funds.

In the light of the findings of the thesis, the alternative investment fund condition should, *de lege ferenda*, be included in Section 9(6) of the ITA instead of Section 9(5) of the ITA. Even though the new condition makes it easier to verify the fulfilment of the conditions at the level of Finnish private equity funds, the condition has an unnecessary negative impact on Finnish private equity funds not governed by the AIFM Act. Since all Finnish private equity funds are not alternative investment funds under the AIFM Act, these funds fall out of the scope of application of the special tax regime unless they become alternative investment funds. Therefore, current Section 9(5) of the ITA requires such funds to choose between the special tax treatment for their foreign investors and flexibility of their investment activities.

[403] See Press release of the FVCA 2018.
[404] *Ibid*.

Obviously, the objective of the legislator was not to exclude such Finnish private equity funds from the special tax regime.

For the purpose of ensuring the achievement of the objectives of the special provisions, the Finnish Ministry of Finance was requested to follow the functioning of the special provisions[405]. According to *Mikkola*, the feasibility of Sections 9(5) and 9(6) of the ITA is monitored by the Finnish Ministry of Finance[406]. Constant monitoring and evaluation of the feasibility is indeed necessary in order to prevent a repetition of needlessly making Finnish private equity funds unattractive target funds for foreign investors.

Having regard to all the foregoing considerations, the Finnish Ministry of Finance should be particularly attentive to the tax treaty condition imposed on foreign investors. Although the Finnish government held in connection with the enactment of Section 9(6) of the ITA that the condition is justifiable by anti-evasion reasons[407] and rationale of tax treaties[408], one should not ignore the fact that the condition might become problematic in complex fund structures. Additionally, it is undeniable that the condition excludes all potential foreign investors not residing in a state that has an ongoing tax treaty with Finland.

If the percentage of foreign investments in Finnish private equity funds does not rise at least to the European average level, the Finnish Ministry of Finance should investigate whether the insufficient development could be linked to the tax treaty condition. In case there is a connection between the insufficient development and the tax treaty condition, the suggestion to abolish the condition should be revised. The review should be carried out by weighing potential benefits of the amendment against possible risks related to anti-evasion and base erosion in Finland.

Even though the conditions are divided into three categories in this thesis, the fulfilment of the criteria is ultimately in the interest of foreign investors willing to benefit from the special tax treatment. Naturally, Finnish private equity funds and funds of funds are also interested in satisfying the requirements in order to attract investments. However, legal uncertainty and additional administrative burden might deter foreign investments from Finnish private equity funds regardless of the good intentions of the special tax regime. Hence, the Finnish

[405] See Comments of the FVCA 2018, p. 4.
[406] Interview with Mikkola 2019.
[407] Government Proposal 64/2005 vp, p. 6. See also Government Proposal 306/2018 vp, p. 12.
[408] Government Proposal 306/2018 vp, p. 12.

Ministry of Finance should also pay attention to the feasibility of the national legislation from the point of view of funds of funds as well.

Despite the challenges discovered in the analysis, the extension of the application of Section 9(5) of the ITA to also cover investments made through funds of funds was a big step forward[409]. Taking into account all incentives, events, such as the world-known start-up conference Slush, and other actions promoting economic growth in Finland, the amendment of the special tax regime is logical and coherent within its context. However, only time will tell if the special provisions have been successful in attracting more foreign capital in Finnish private equity funds and thus helped the funds to develop a greater number of their portfolio companies into global success stories.

[409] The same standpoint was also shared by *Vehviläinen*. Interview with Vehviläinen 2019.